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Accounting in the Boardroom

The aim of this paper is to add an accounting perspective to the current discussion of board roles. Three roles for boards – control, strategy and service – are used to build a framework related to usage of accounting in the boardroom. This study shows that boards use both financial and management accounting information, and suggests that the roles of boards help explain the nature of accounting information used. Preliminary results of a qualitative study are presented along with suggestions for further research.

1. Introduction

Corporate governance is undergoing frequent changes (Ritchie et al., 2000). Especially recent corporate scandals have raised questions of the level of corporate governance, emphasizing the need for common guidelines and increased expertise in this area. As a result, the role of the board of directors as significant decision-makers responsible of the corporation's success has become the focus of discussion.

This research looks into how and why accounting is present in the boardroom. There has been an increasing amount of research of boards in the field of corporate governance but the inner workings of these important decision-making organs are yet largely unexplored. There is especially a lack of information of how boards receive and use accounting information and why accounting information is either present or absent in the boardroom. This paper develops a framework that helps explain the part accounting plays in the boardroom under various circumstances.

1.1 Corporate governance and boards

Research conducted in the field of corporate governance has previously focused on the following themes, often linking them to firm performance: executive compensation and incentives (e.g. Beatty and Zajac, 1994; Core et al., 1999), board composition and size (e.g. Kesner & Johnson, 1990; Bathala and Rao, 1995; Hermalin and Weisbach, 2003; Kang, Cheng and Grey, 2007), auditing and audit committees (e.g. Deli et al., 2000; Abdel-khalik, 2002; Xie et al., 2003), passive role of the board – managerial dominance (e.g. Mace, 1971), and corporate governance structures in different countries (e.g. Shleifer and Vishny, 1997). Thus, existing corporate governance research mostly concentrates on the inputs and outputs of board work leaving the inner workings of boards - such as the usage of accounting in the boardroom - with limited attention.

The discussion of the roles of boards has been ongoing for several decades (Mace, 1971; Zahra & Pearce, 1989; Pearce & Zahra, 1992; Johnson et al., 1996; Hung, 1998; Jonsson, 2005; van den Heuvel et al., 2006). Zahra and Pearce (1989) suggest that there are three interrelated roles played by boards: control, strategy and service. The control role includes monitoring, evaluating and rewarding management, protecting shareholder interests, and the right to select and dismiss the CEO. The strategic role, in turn, emphasizes board involvement in developing organization's strategy. Finally, the service role includes several elements, one of which Pearce and Zahra (1992) describe as performing ceremonial functions. Recently, there have been several worthy suggestions as to how these roles should be further developed (see for example Jonsson, 2005; van den Heuvel et al., 2006). Since no consensus of a new typology has been reached, the three roles as identified originally by Zahra & Pearce will be utilized. These three roles – control, strategy and service - are used as a key framework in this research. It should be noted that Jonsson (2005) finds that one board can either represent a single role or a mixture of roles, and that the role of a board can change over time.

1.2 Management accounting

In the field of management accounting, managerial decision-making and the role of accounting information have been extensively studied (see e.g. Simon, 1955; March and Simon, 1958; Feldman and March, 1981; March and Sevon, 1984). Different uses of accounting have also been explored, accounting controls being one of the older areas of research (for a historical overview, see Armstrong, 1987) and strategic management accounting a more recent acquaintance (Simmonds, 1981; Bromwich, 1990; Wilson, 1995). Additionally, a contingency perspective has been widely used in the accounting literature, suggesting that there are various external and internal factors that influence the nature and suitability of an accounting system (for an extensive overview, see Chenhall, 2003).

Burchell et al. (1980) examine how accounting operates in practice arguing that levels of uncertainties influence the role of accounting in decision-making. They suggest that when uncertainties are low, accounting can give answers but as uncertainties increase, accounting can be used either as a learning tool, as a political ammunition or, eventually, as means for rationalization to legitimize action that has already been decided upon (Burchell et al., 1980).

The results gained from studying operational management described above are yet to be extended to board setting. Even if these management level results serve as a good starting point, their direct applicability cannot be assumed without further study since there are significant differences in the decision-making styles of these two levels. For example, whereas managerial decision-making is based on choice between several alternatives, board members are usually presented only one alternative at a time.

1.3 Gap – this research

There is a need for a theoretical framework to help explain accounting in the boardroom. Unraveling this area begins by identifying the part played by accounting in different roles that the board has. The goal of this study is to develop a framework starting from the results gained from explorative interviews, and also utilizing prior

corporate governance literature and theories, especially the aspects related to the roles of boards.

This research applies the roles of the boards by Zahra and Pearce (1989). These roles and their theoretical origins are presented in table 1. Each role is based on a different theoretical view. These three underlying theoretical views are all concerned with the same basic questions of corporate governance. However, they differ in how they approach and explain some key areas as illustrated by the table.

Zahra & Pearce	Theoretical background	Board's main role	Connection to management	Board member	First priority
CONTROL	Agency theory	Monitor and control	Independent of management	Critical observer	Interest of the owner
STRATEGY	Resource dependence	Set policies and strategies	Advisors to management	Active participant	Interest of the company
SERVICE	Managerial hegemony	Ratify mgmt decisions	Friends with management	"Yes-man"	Interest of the manager

Table 1. Three roles of boards

The agency theory (Jensen and Meckling, 1976) assumes that board exists primarily to safeguard the owners' interests. This is done by controlling and monitoring management decisions, which in turn can be done most efficiently when the board is independent of the management. On the other hand, resource dependence perspective (Pfeffer and Salancik, 1978) sees board members as important additional resources, providing the organization with an access to scarce information. This perspective emphasizes the role of board members in setting policies and strategies, and thus actively participating in the steering of the company. This requires a closer working relationship with the management. Last, managerial hegemony (Gramsci, 1971) believes that board members are unable to bring advantages to owners or to the organization. Instead, board is dependent on the information provided by the management, and both unable and unwilling to influence management's decisions. However, since companies must have a board as required by law, the role of the board is to be as unnoticeable as possible, not to disturb the management.

The three roles presented above - control, strategy and service - arise from internal pressures, needs within the organization to have a board to either control the management, to help management in strategic issues, or to support management by legitimizing its power. These roles each partially explain existence and nature of accounting in the boardroom. First, the control role pointing out how accounting is used as a means of board to control the management; then the strategy role emphasizing how accounting can be a tool used by management and board together to develop strategies; and third the service role showing how management can exert power by controlling the availability and nature of accounting information available to board. Thus, all of these first three roles identified deal with the relationship between board and management, and the – possibly conflicting – roles accounting can have.

This research takes a look into the boardroom from an accounting perspective analyzing the roles in this context. The main interest lays in exploring why accounting information is present and how it is used by boards in controlling, making strategic decisions, and performing ceremonial functions. The outcome of this research is a framework that is developed into propositions that offer a fruitful starting point for future research.

The structure of this paper is as follows: next the research design will be presented. Then focus shifts to empirical evidence which is discussed and developed into a framework. Last, there is a discussion with development of propositions.

2. Research design

A preliminary understanding of the phenomena is reached by approaching this topic both empirically and theoretically. The phases of this research include: literature review, empirical data gathering and theory building. The exact research problems, as well as the framework suggested, arise from the empirical evidence, instead of having been created by the researcher ahead of time and merely tested during the empirical data gathering. The data gathering and theory development have taken place simultaneously as over-lapping processes.

The empirical research includes in-depth theme interviews. Twelve experienced directors who are each members (and/or chairmen) of several Finnish boards were interviewed. These interviews were taped and transcribed. Each interview lasted in average 1½ hours (45 minutes to three hours). The interviewees were selected among well-known individuals who have had a broad and lengthy exposure to board work. These individuals include professionals from different fields and backgrounds. Knowledge of which individuals to interview was also gathered by asking each interviewee to name other board members who should be contacted. This approach also made it easier to gain access to new interviewees. All interviewees who were requested to participate agreed.

In conjunction with the interviews also two network organizations (one association and one company) of professional board members focused on enhancing corporate governance in Finland were contacted to allow for a wider access in the future. In addition to the interviews, also written material was accessed and utilized to build an understanding of how boards function. This material includes minutes and all written communication as well as calculations presented to one board year 2003.

3. Empirical evidence

The interview results reveal that accounting serves many different purposes in the boardroom. The interviewees indicated that accounting reports used as a means of control are nowadays taken for granted, and board members usually receive such accounting information regularly in a standard format (control role of accounting). There were differing views on the use of accounting in strategy development and strategic decision-making; some interviewees described how accounting was an integral part of strategic discussions, whereas others claimed that these areas called for experience and intuition, not accounting, suggesting that this area especially requires further examination (strategy role of accounting). However, all interviewees agreed that accounting information is present in boards whenever decisions are made, even if some saw no need or role for accounting in certain situations.

“Accounting actually makes three types of reports. First, about past - which should be fairly exact – this is about board control, that we control that

everything goes and all areas go as they should and that there are no bombs (major negative surprises) built in. And of course in this function it leads to decisions that a certain department cannot be kept because it causes so much losses or if the whole company is doing bad then we cannot keep the CEO. Then there are the next reports which are more uncertain, and those are budgets, or let's say the budgets for the next year and so. We also make this type of decisions based on those, but there the uncertainty is always larger because it is future and we don't know what it is. And then sometimes this accounting (function) makes these investment calculations and long-range budgets, and that is very vague information [laughs]. And there the role of accounting is very small in actual decision-making. It is the CEO or someone else who presents these issues; it is really about his / her credibility and not about the calculation because you can show almost anything with a calculation [laughs]..." (D)

Interviewees explained that accounting information was mostly provided by management and some implied that there were situations where management had already made a decision, nevertheless bringing the issue to board for a quick approval and legitimation (service role of accounting). On the other hand, some interviewees described situations where board members had to take into account factors reaching beyond those introduced by management, such as the implications of an investment decision to an area's employment situation and the results this would have to the organization as well as its stakeholders. Some interviewees gave examples on how accounting procedures had changed as a result of a board member suggesting new uses for accounting that had proven good at another board.

The different purposes of accounting identified as a result of the interviews can be categorized as the roles of accounting (in parenthesis above). Next, a potential new framework is introduced. This framework is built based on the results of the interviews, and the findings fit with the roles identified by Zahra and Pearce (1989). Instead of representing alternative roles of accounting, these three roles should rather be seen as complementary, often overlapping roles of accounting. Next each role - strategy, control, and service - is presented with empirical evidence.

3.1 Control based on financial accounting reports

Financial accounting information is presented to the board in a standard format that remains the same from one meeting to the other. Using a standard format saves time

from the board and money from the company (less time and resources are needed to produce the reports when they are in standard format).

”... most of [financial information] is in standard format and then as a board member you get used to seeing the same set up many times and then it is easy to get to know it. Then some issues might be asked that can not be seen... a CFO or similar is always there so that is no problem and it is good of him to know how to answer these questions or at least say that he will produce this information.” (E)

“ ... if the reporting works well, then the reports are tight, factually they do not have many pages, only the most important figures, and when the board meets it already knows how the company is doing... and uses its time to look forward, I think that this is the way to do it. When the board discusses more than half an hour what this report means or what page information supporting this other view point is on, then it is doing wrong things. So when reporting works then the board can focus on the right things...” (P)

This accounting information is used to control and monitor the management, and in an extreme case the CEO could be dismissed due to a problem in this area.

“... the standard information, financial standard information, it is important because of the reason that then a board member can keep up all the time and know how the company is doing and then it is also so that if in the next or a following meeting it comes up that this issue should have been told earlier and it has not been told then it is not a good situation if it is any more critical issue...” (E)

Financial accounting information is often reviewed in detail by the audit committee which then reports to the board. This approach frees time from the entire board. Since the board members that are most knowledgeable in accounting sit in the audit committee, this way the board focuses its best resources to take care of this particular task.

”... Now that we have started using these audit committees, in (company X) I was in it and then it was so that audit committee was the one that had the possibility to take a little deeper look into these numbers and we usually had the habit of having the audit committee gather the previous afternoon and the board meeting was the next morning and then the audit committee reported to the board that ‘we have now gone through these and gotten all additional information that we might have asked for and our understanding is that things are in order’ and then the board did not have much time to spend on that part... But on the other hand if it was critical then of course we would have

had to spend time but when things were going well this information... It was not necessary to spend a lot of time.” (E)

“If the company has an audit committee that for example in a listed company always goes through the quarterly report and meets with the head auditors, then it is this audit committee that focuses on the correctness of this financial information... The management has to scarp because a certain part of the board members really focuses into the correctness of the given information, and its structure and content in a completely different manner than if it was just a fifteen minute thing in a board meeting... So it has brought the focus into this and it also intensifies the cooperation between the auditors and the board.” (K)

Even though financial accounting information is used to control the company and its management, there are reasons that would indicate management accounting reports might give a more accurate picture when looking at the performance of the various profit centers within the company. For example customer, product and business unit profitability are important standard reporting areas that are based on management accounting information. Question arises whether all control information should be management accounting instead of financial accounting information.

“...this is an issue where I always personally use a lot of time that I ask in those companies’ boards, the boards where I sit, also the bookkeeping balance statement so that I see genuinely how it looks. And in that way it has to do with accounting that it would be good to always go through the principles, how things are recorded, because there the practice varies relatively much from one company to another. Some companies want that as much as possible is written as cost, others want to show as good a result as possible so that investors would be happy in the stock exchange. Some imagine that the most important thing is to show that there is a lot of research so that all the work some engineer does is suddenly counted as R&D because it is allowed based on EU directives. And thus somehow it would be good that in board work you could genuinely know that for example information from different subsidiaries is comparable, really, and here I would see that there is a very big change ahead, that management reporting should be very orthodox always independently made the way the company has chosen and bookkeeping information can be whatever it happens to be. But this makes still at the moment for example internal benchmarking difficult in many companies because in one country certain expense is a variable expense and in another it is fixed and in a third it is not an expense at all but it should be activated and so forth...” (P)

3.2 Management accounting information needed for strategic decision-making

Strategic issues are discussed in the boardroom, and the calculations supporting these discussions are made during the course of the dialogue between the management and the board. This strategic dialogue is often engaged in over several board meetings.

“I would say that I think that the best way is such that when we discuss a new big issue, that the whole idea, concept is first presented as an idea only, without any numbers or people... As an idea and concept, what if we did this type of a move, an acquisition, building the car house, a split, an incorporation, giving up something, what if... What thoughts this brings up, does it feel possible as an idea or good or is it for some reason completely insane. And then in the next meeting you can more specifically discuss what it could mean, there could be some numbers and some people and so forth, based on that you could build some alternatives. And then in the third meeting you could select from the alternatives. That is the way I feel works the best, and there I would say, even if I do not want to market any company in specific, that there the way the board of (company Y) works is a lot better than others... I think that we start to see similar decision-making in the board of (company Z) now; it is probably partially due to the fact that (board member and partial owner of company Y) is the chairman of (company Z's) board. I myself hate situations where the board has to decide issues where alternatives are not known and where risks, there is no time to discuss risks, and where the complete financial impact that follows from the decision is not known well enough. So the board should never just decide, it should process, it should understand, it should be aware of what alternatives exist, and preferably so that when the final decision comes it is simple and unanimous.” (P)

Unlike financial accounting information that is used for control purpose, and presented in a standard format, management accounting information used in strategic decision-making is presented in different forms, based on what is needed. These strategic management accounting reports are situation-specific and thus are prepared separately for the board.

“It depends a lot on the decision in question, if we calculate which solution is most profitable, whether a voluntary pension fund is left on the responsibility of the company or whether to sell the pension fund, that is most likely completely numeric. If we discuss how to take over an acquisition target, numeric information is [only] a little more important than information related to people. And the course of the decisions and hierarchy if you talk about an investment that is big and long-term, then numeric information influences in the way that you get a range that if it goes bad it goes like this and if it goes well it goes like this, but after that you have to find this, you have to have the

courage, then it [accounting information] supports, but it is not necessarily the information that rocks the decision one way or the other, it just gives a safety circle that this feels good, but based on the information it is different.”
(P)

To save time and money, usually only one alternative is presented to the board. The board, however, might engage in strategic dialogue by asking for more information and alternatives. Once it is time for the final decision, usually only one alternative is left on the table.

“Pretty often the calculations that are brought (to the board), there is only one alternative. The board does not like that, they would like to see if there is another alternative, they want to question. A good board then asks what other alternatives there are, have you calculated those? If the answer is no it might be good to say that let’s leave this issue to the next board meeting that we have time to see some... Investment propositions do not necessarily come from the CEO’s table, they might be from lower in the organization and often it is so that the Production Manager wants that this investment is done. (And the board asks) what if we only get half the equipment or make some totally different arrangement... Often a sensitivity analysis is also conducted. It is good to know that if that falls 10% of something else fails, that we can calculate and observe.” (W)

3.3 Ceremonial role of accounting

Sometimes either the management or the owners dictate, and in these cases the role of accounting is often small. Accounting can be used by these parties (management, owners) as a tool to convince the board. In these cases the board is often merely interested in the cash flow effects of the decisions. Below is an example where a major owner and board member is describing a decision-making process from his viewpoint.

“... for example when we looked last summer, we looked at alternative dividend policies, we left from the fact that the taxation on dividends is going up, so we talked about one concept that felt pretty good but then I calculated on different yield levels, that is, yield per net assets, what it in practice would mean as a dividend in relation to the company’s profit after tax, and I realized that in couple of cases, that this share of the dividend was after all too high, when we realized that mathematics showed that what felt good was bad, and we changed this algorithm and noticed that now this works, and we can show our directors that if the company is doing well the part that goes as dividends to the owners goes down; the more they make a good result, the more they get

money that they can use for investments and to develop operations. Then everybody was happy, so there the mathematics played a big role.” (P)

The board often legitimizes a decision already made by the management. In these cases the role of the accounting information is small, or accounting information might be used to lead the board to the wanted direction.

“...the usual decision-making happens usually so that the CEO presents the issues and the board nods and says yes. That is 99% of all decisions.” (D)

“...I have felt that there are these mathematicians who can lead the CEO’s and board’s thoughts to certain direction by showing reports where criteria are fitted purposefully and certain statistics are shown...” (D)

Board merely legitimizing the managerial decision might seem like poor corporate governance; however, one interviewee stressed this as a form of trust that is important in functioning as a team. He felt that a board that cannot trust is lacking something.

“...running a business is nothing other than intelligent people discussing. It deals a lot with credibility issues, whether you believe in calculations that have been made, it depends a lot on the credibility of the person making those calculations and that is the problem...” (D)

3.4 Summary of roles

The empirical findings support the classification by Zahra and Pearce (1989) that there are three main roles for boards, control, strategy and support. New evidence was found about the usage of accounting. The findings are summarized in table 2.

	ROLE		
	CONTROL	STRATEGY	SERVICE
INFORMATION			
NATURE	Financial accounting	Management accounting	Cash flow (more empirical evidence needed)
SOURCE	Through audit committee	Dialogue with management	Given by management

Table 2. Summary of findings: accounting and board roles

First, to fulfill its control role, a board uses financial accounting information that is often reviewed in more detail by the audit committee. Second, management accounting information is utilized as a part of the strategy role of the board. Both the strategy and the calculations made to support the strategic decision-making are developed as a dialogue between the board and the management. Third, boards have additional, more ceremonial roles to play. Likewise, also accounting seems to sometimes play a more ceremonial, or perhaps legitimizing, role. This third role helps explain why accounting might seem absent sometimes, or the interest in accounting information might seem small. It is suggested that in these cases the main interest might often lay in finance (more specifically cash flow situation – whether the company has money or not), rather than accounting.

4. Discussion

This research focuses on establishing a framework on usage of accounting in the boardroom. Since the area is new, the research design combines empirical data gathering – interviews – with simultaneous theory development. Prior literature and theoretical approaches are utilized to build a new framework to explain accounting in a board setting. Three roles – control, strategy and service - are found, each having roots in a separate theoretical foundation. Utilizing an established model of roles of the board, this research continues and adds on the current discussion in the area of corporate governance.

Finding several uses for accounting is consistent with Burchell et al. (1980) who noted that accounting can play different roles in different situations. However, when compared to the roles identified by Burchell et al. (1980), the usage of accounting in the boardroom examined here could be seen as macro-level. Combining the roles of accounting in the boardroom suggested here with the roles introduced by Burchell et al. (1980) still requires further consideration.

This study is naturally not without limitations. Since it is the first attempt to explain accounting in boards, it is explorative in nature and focuses on a limited number of interviews. Once this initial base has been created, the framework can be used as a

basis for further research. One possible way forward is testing of this framework by means of survey research.

Future research should aim to tie the usage of accounting to board or ultimately corporate performance. Also the case study approach should not be forgotten since it enables a detailed examination of accounting in boards. This approach also offers the possible alternative to concentrate on a smaller number of roles. Based on results gained here from the interviews, especially the strategy role of accounting in the boardroom might offer an interesting research area.

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