Executive learning in entrepreneurial firms and the role of external directors

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Introduction

Theoretically, the role of external or non-executive directors in the growth process of small, growing companies or “entrepreneurial firms” can be important, especially with respect to the relationship between the key entrepreneur(s) or executive directors and the external directors. Theoretically, external directors could have a critical role in the executive learning process. For example, they may be expected to bring experience, knowledge, discipline and rigour to strategic planning; they may also bring contacts, planning skills and a number of other intangible benefits to the entrepreneurial company. This intervention may be crucial in the development process of such companies and the way the executive directors and entrepreneurs learn. An external director, theoretically, should be able to build a long-term relationship with the key or founding entrepreneur and bring his/her own network of contacts to aid the growth process.

However, in the field of entrepreneurial research, we have limited evidence on the nature and impact of external directors in small companies and also little evidence on the impacting factors (recruitment, payment, power sharing) on director relationships. For example, Huse (1998, p. 218) considers that internationally “research into boards (of directors) is still in its infancy”.

Literature on the role of outsiders in the board of directors, in a European context, is beginning to emerge through recent studies into relationships between insiders and outsiders on boards, for example:

- on the importance of trust in relationships (Huse, 1996);
- on Board members’ roles (Daily and Dalton, 1994) (here also more research into the role of Board members has been called for (Huse, 1998)).

In the USA, partly due to the more advanced nature of the venture capital sector, research has focused on the value-added that may

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Entrepreneurialism, Learning, Non-executive directors

Abstract
Provides an analysis of the role of “external” or non-executive directors and their relationship with executive entrepreneurs in small but entrepreneurial (growing) companies, focusing on their influence on executive learning. We provide qualitative analysis of research based on 45 face-to-face interviews. Despite the importance given to individual executive and organisational learning in large companies, comparatively little literature exists on executive entrepreneurial learning in small companies. The factors that can affect such learning are discussed with emphasis on the role played by external directors who, it is argued, are likely to be appointed in such companies due to the need for additional expertise and knowledge in a rapidly changing environment.

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result from the addition of directors to the entrepreneurial team. For example, in an exploratory study, Rosenstein (1988) has suggested that such venture capital can provide value-added through appointed external directors in high technology companies.

In the UK context, external directors are known as non-executive directors (NEDs). They have received considerable attention through their potential role in corporate governance recommended by the Cadbury Report (1992). In the UK there may be some blurring of the role of NEDs and other external advisers such as consultants and mentors. This paper is concerned with a study that was limited to small, growth companies or “entrepreneurial firms” that were employing at least one external director or independent NED. Such external directors, in the UK, have a specific legal function and contractual relationships related to stewardship functions on behalf of shareholders. Thus, although NEDs have been commonly appointed in large companies, following the recommendations of the Cadbury Report (1992), there are no such requirements on the part of small, non-quoted companies to follow the Cadbury recommendations. In small companies, in the UK, NEDs are still comparatively rare, even though the growth of the venture capital sector has meant a concomitant wider use of external directors or NEDs, appointed due to requirements of venture capitalists.

Executive learning in small companies

Despite the considerable literature that now exists on organisational learning, drawn from a number of different ontological perspectives (Easterby-Smith, 1997), most of this literature focuses on large organisations. Although there is discussion of the dichotomy between individual and organisational learning, when executive learning is discussed this is usually in the context of large organisations (Argyris and Schon, 1978). In small companies executive learning will closely influence and mirror organisational learning. The firm may not develop unless the entrepreneur is able to learn. It is arguable that the processes that influence the extent of learning in small companies will be different. For example, it has been claimed that level and sophistication affects the quality of the experiential learning of the entrepreneur (Johanisson, 1986; Szarka, 1990). The importance of the external environment for small companies has also been highlighted by Gibb (1997), who has argued that relationships with external stakeholders (customers/bank managers/suppliers and others) govern the learning climate in small companies. Thus, theoretically, external directors, however appointed in small companies, are likely to have an important impact on entrepreneurial and firm learning.

Developments in the modelling of executive and entrepreneurial learning are concomitantly notable by their absence in the literature. Alternatively, entrepreneurship can be viewed as a “learning experiment” (Jovanovic, 1982) in which the executive entrepreneur’s survival and success depends on their ability to learn. The importance of the acquisition of knowledge has been recognised in individual learning, including the distinction between tacit or implicit knowledge which is not codified (Polanyi, 1967) and explicit knowledge which is codified (Fleck, 1996).

In entrepreneurial companies which may be undergoing rapid change, it could be that learning is dictated by reaction to critical events. Indeed, such approaches assume that the growth patterns of companies follow a life-cycle pattern of development where each stage or phase is preceded by a management “crisis” (Greiner, 1972). How the company resolves that crisis determines their ability to progress to the next stage of this life cycle. The growth patterns and development of small companies are poorly understood. Central to successful entrepreneurial development will be executive learning. In small companies we do not understand how entrepreneurs learn. This paper argues that one method where such executive learning can be successful and transferred to organisational learning is through the use of external directors.

Learning and the entrepreneur

Recent articles have identified our limited knowledge of the factors affecting the learning process and the ability of entrepreneurs to learn in small- to medium-enterprises (SMEs)
Despite the received wisdom that intervention through training and/or advisory services can impact on entrepreneurial abilities and by implication, small firm performance, Storey and Westhead (1996) have noted, from a survey of the literature, that there is no apparent link between formal training and improved performance of small firms. This would indicate that formal personal management development and training of the entrepreneur appears, paradoxically, to have no impact on improved performance. Gibb (1997), however, proposes that development of the entrepreneur is affected by the extent of interaction with “stakeholders” in the small firm environment (for example, customers, bankers, creditors and supply chain relationships). This implies that intervening to improve learning from interaction and experience should improve entrepreneurial ability and performance:

Learning better from experience implies bringing knowledge, skills, values and attitudes together to interact upon the learning process; it therefore fundamentally demands an action-learning approach (Gibb, 1997, p. 16).

Reconciling these apparently different views can be achieved by recognising that learning outcomes from changed behaviour of the entrepreneur often have subjective outcomes that are not easily measured, such as:

- changed strategies;
- changed processes of decision making; and
- subtle changes in relationships with “stakeholders”.

However, our limited knowledge and understanding of the interaction of learning and the entrepreneurship process remains one of the neglected areas of entrepreneurial research and (hence) understanding. Case studies of the features of learning organisations have been developed in some detail (Kline and Saunders, 1993), yet little equivalent research has been undertaken within small firms, partly because of the lack of appropriate ethnographic and case study approaches that are capable of revealing the complex and often subtle mix of factors that will affect entrepreneurial learning.

Gibb (1997) has argued that the entrepreneur must react and change behaviour as result of the interaction with a wide infrastructure of stakeholders, competitors, customers, providers of resources, advice and materials, while operating with a small workforce, which means that concepts involving team-based learning may be too narrow. A key critical part of this interaction in entrepreneurial development will be the role of an external director. The cyclical concept of learning from experience and adjusting behaviour is important to the entrepreneurship process. The entrepreneur must learn how to react to incidents, to changes and learn from problems encountered. A priori we might contend that such a process, for the small firm entrepreneur, will be imperfect; however, we would expect there to be some form of learning in the reaction to business problems; what will be crucial is the effectiveness of the individual entrepreneur in conducting that process. Potentially, the NED has an important part to play in the entrepreneurial process and reaction to critical events.

### Potential influence of external (non-executive) directors in small companies

As we have already indicated, external directors in small companies may undertake a number of different roles. A number of factors may affect the impact and influence of external directors in such circumstances. Huse draws on qualitative studies to discuss how the importance of trust and emotion can affect director roles in different small companies, which may reflect the interest of different stakeholders (Huse, 1990; 1998). As suggested above, external directors may affect strategy by bringing additional, informal networks, external directors can provide contacts in new markets and in acquiring resources (Borch and Huse, 1993). External directors may also improve the credibility of a firm in new markets (Hambrick and D’Aveni, 1992; Keasey et al., 1994).

External directors may have other roles in small firms than merely those of monitoring and evaluation. Apart from bringing additional skills and important contacts, such directors may be able to influence entrepreneurial and growth strategies, approaches to marketing, problem solving, strategic planning, recruitment, training and staff development. By providing advice to the entrepreneur or entrepreneurial team, external directors take on the role of
counsellor, of someone who can be used to sound out ideas and remove some of the self-reliance that can be dominant with some entrepreneurs. These counselling and advisory roles provide an extra dimension to the role of external directors in smaller and entrepreneurial firms (Daily and Dalton, 1993; Mileham, 1995). Mileham (1995) has also indicated that external directors may have an impact on the strategic planning processes of the small firm, through, for example, raising awareness of strategic environmental issues and incorporating these into the planning procedures of the small firm.

Despite the wide divergence of different roles that external directors could take in small companies, we concur with the model proposed by Zahra and Pearce (1989) which suggests that the roles of directors are determined by attributes (such as characteristics and composition, i.e. outsiders v. insiders) and by contingencies including company size. The roles of directors determine strategic outcomes and in turn performance of the company. Zahra and Pearce (1989) suggest that in small companies “cronyism” will affect composition and roles of directors, a factor that may affect appointment. For example, they comment that:

In smaller firms, boards tend to be under-utilised cronies of the owners or CEOs (Zahra and Pearce, p. 294).

In small companies, that may need to recruit additional board members, such cronyism may affect the search and appointment. Thus, how small companies find an external director was one of our research issues.

There may be a number of reasons for appointment of an external director. Historically, in the UK, external directors have often been appointed in family firms to bring independence to boardroom discussions; external directors may also be appointed due to a desire to bring additional expertise to the board of a small company or to reduce the isolation of a founding entrepreneur. In Scotland (the area of study) public sector development agencies have also nominated external directors to the boards of small companies.

The rest of the paper examines the methodology of the fieldwork, a discussion of some findings on the impact on executive learning in small companies and a summary and conclusions.

Research methods

The target sample for this research was small growth companies in Scotland. In arguing for the need for research on a largely unexplored topic, this paper has already established that, certainly in the UK, little was known about the use of external directors in small companies, i.e. who uses them, how they are used, and who the NEDs are. Not surprisingly, therefore, the research team faced an initial problem in identifying potential interviewees. Logistically, the problem of identifying potential interviewees was overcome largely by the team approaching public sector agencies, the local enterprise companies (LECs), venture capitalists and other agencies for potential contacts. This gave the research team an initial list of contacts. We sought to expand this by various means; further contacts were sought with large consultancy and accountancy firms, with a networking agency working with high technology and growth firms and with our own “snowballing” techniques. We also sought local publicity for the research which might lead to further contacts. Media searches also revealed a small number of contacts. Snowballing further expanded the database of potential contacts, whereby entrepreneurs were asked on completion of their interviews if they could provide the names of other firms who they knew had utilised external directors or NEDs. This approach, however, resulted in only a small number of new potential contacts, and is perhaps indicative of:

- the well-documented “isolation” from their peers that small firm entrepreneurs may experience (Storey, 1994) (and for which external directors may offer a networking remedy); and
- the problem that this research sought to surmount, i.e. that little indeed is known about the use of external directors, in UK small companies, even by the small firm community itself.

The study has been undertaken through face to face interviews with key and founding entrepreneurs in small, entrepreneurial, companies in Scotland. Although over 50 in-depth interviews have been completed, recorded, transcribed and analysed for the purposes of this paper, analysis is restricted to 45 of these interviews. This was necessary since some entrepreneurs had to be excluded.
from analysis because they were not engaged in a true NED relationship (as defined for legal purposes). All the interviews have been conducted face to face by the authors (apart from one telephone interview).

For the NED set, the authors constituted the research team who carried out the interviews over the period from Autumn 1997 to Summer 1998. A semi-structured interview guide was used, but entrepreneurs were in many cases encouraged to talk freely and candidly about their relationship with external directors. This open discussion was achieved in spite of some initial reticence, even downright reluctance by some entrepreneurs to participate in the research. As with building up the database of potential contacts, therefore, actually gaining access to suitable entrepreneurs and then carrying out the interviews was a slow process. All the interviews were taped and transcribed and have been analysed on a qualitative software package.

Findings on external directors and entrepreneurial learning

Following the discussion in the introduction, the discussion of our evidence is organised under three headings where external directors may be expected to have an impact on entrepreneurial learning:

1. the ability to impart knowledge;
2. the ability to set challenges and influence strategic decision making; and
3. a comparison of impacts with critical events.

Ability to impart knowledge

It is arguable that individual entrepreneurs have to learn how to assimilate and process information and knowledge, while operating in complex environments. Unlike large firms there will be few filters of information, hence it is the efficient processing and assimilation of knowledge that is one of the keys to successful entrepreneurial learning. It can be expected that external directors will bring considerable experience; however, this experience may be either specialist (e.g. related to industry sector/technology) or general business experience (such as experience of entrepreneurial management in small companies). The interview results indicated that bringing previous general experience was rated in the top six actions (out of a pre-determined list of 20; see the Appendix) and that this was more important than bringing specialist experience. It was environmental awareness and processing that external directors were valued for. As commented by one entrepreneur below:

. . . he [the NED] is very good at giving overviews as to the state of the businesses elsewhere and the general state of industry . . . if we were to say “xyz”; he will, because of his other contacts in non-executive directorships, say that is exactly what is happening elsewhere or you’re going against the trend and it puts you in a position of knowing (Case 23).

Increasing the processing of information improves the role of the entrepreneur in reducing uncertainty. For example, another entrepreneur commented on the way that information and improvements in management had occurred since the appointment of the external director:

. . . drastically increased [info] from management team in terms of delivery and discipline . . . much more analysis of own roles . . . takes the pressure off me . . . [and] vastly reduced uncertainty in growth areas (Case 12).

Not all of our companies had a positive relationship with an external director. A minority of entrepreneurs had limited benefits from their relationship. Nevertheless, even here such entrepreneurs could recognise the potential value (with the right external director) of such relationships. For example, one entrepreneur was employing an external director whom he considered to have limited expertise but still considered that:

. . . they [NEDs] should add expertise to the company . . . they should help steer the company. Unless a NED has the experience to do that, then they are no value to the company (Case 16).

Setting challenges and influence on strategic decision making

Executive entrepreneurs can be expected to respond to challenges, yet how they respond and overcome such challenges is an important part of their development and learning. The ability required of the external director is to set achievable goals and challenges that support entrepreneurial development. Through further support/encouragement external directors can influence how entrepreneurs respond to new challenges. In fact guidance and support was rated as the most important perceived action (from our pre-determined list of 20 actions) taken by external directors.
The importance of setting challenges in the small company environment for executive learning is represented by the following statement from one of our entrepreneurs:

I think the most important thing of course is that it gives you somebody to challenge you, particularly in a small business when you are a fairly dominant part of it. It’s extremely important that someone challenges what you do and can actually argue with you . . . (Case 31).

The most important value-added, however, was perceived to be through benefits in strategic planning. For example, 80 per cent of our entrepreneurs in the interview sample agreed that external directors had an impact and value-added in strategic planning. Although we would expect through boardroom discussions that such impacts would be revealed, the importance of such impacts was revealed by many comments on the value of external directors in strategic planning. Several times the value of a different (outside) dimension in strategic issues was the subject of comment. For example, that the external director could:

. . . bring another dimension to an idea, that I had (not) thought of (Case 23).

And:

. . . they come up with specifics that are very interesting and we follow them. They just give us another dimension really, and if it’s appropriate we take it (Case 7).

This role of providing independent counselling and advice was often reflected by the entrepreneurs discussing a specific issue or strategic problem resulting from decision making as a result of expansion or growth. For example, one entrepreneur comments on this ability to give a different perspective on the following issue:

We’ve had at least a couple of meetings outwith (outside) the Board Meetings and he came down on one occasion, just to run through regional selective assistance . . . but there would be quite a bit of liaising with him on the phone . . . If we felt there were specific problems and we needed to look at it from another angle, then we would ask him . . . [He] gives a different perspective because he’s standing slightly back from the situation [and is] . . . independent (Case 6).

The impact from these actions and roles undertaken by external directors was subjective and in some respects quite subtle taking some time to materialise, but nevertheless, often considered to be very valuable. A typical response on the role and hence impact of external directors is given by the following comment from one entrepreneur:

He’s trying to modify our strategy and add longer term value and change the emphasis . . . He has changed my perception about the need to learn (Case 26).

Relationships were affected by expectations of the entrepreneur on the role that was expected of the external director. In most cases what entrepreneurs wanted was someone independent, often to give a different view of an issue, yet they also wanted someone who had experience themselves as an entrepreneur rather than someone from a large corporation. It was an ability to see a different perspective that was valued. For example, the following quote is taken from an entrepreneur in a mature business:

I think it [the role of the external director] gives a balance to the board. Quite simply, a board gets carried away with its own ideas, it gets into a way of thinking that everyone is comfortable, you begin to get carried away with the technical concept and the NEDs are there as a sounding board and to give us balance (Case 41).

The approach of the external director also affected relationships. Some director roles were restricted to inputs through board meetings; however, others took a much more proactive role to develop close relationships with other executive directors. For example, one external director adopted a proactive role as described below by one CEO:

[Initially] everyone was terrified of him because he was the non-executive director. The fact that he comes in a sort of tattered old check shirt and a pair of cords, there is no threat there (Case 14).

A minority of cases revealed more negative relationships, not based on trust and as a result lacking value added for the company. This limited development of relationships existed where the external director undertook a mere monitoring role, a role that was not proactive. The limited value that can occur was agreed in a minority of cases. As the following entrepreneur comments:

I think NEDs can add tremendous value to a company but experience to date has led me to believe that there are a lot of NEDs out there who simply are acting as consultants for themselves (Case 16).

In the majority of firms, entrepreneurs could cite at least one example of the difference made to decision making. In a significant minority of cases (12 per cent), however, the entrepreneur could not recall a situation
where the external director had made a difference. For example, another view that external directors do not add value was given from the following entrepreneur:

What you need primarily, if you’re spending money, then what you need as a small company is value and value is clearly, what they (venture capitalists) can do to help your business grow. Now, a NED . . . I have some doubts whether somebody who’s there for two days a month can actually add any value. I can understand . . . if you had a very young management team with no real experience then . . . but if you’ve got a management team or a managing director with a lot of experience then really what we have here is . . . it’s not adding any value (Case 36).

Impact with critical events

As discussed in the introduction, Greiner (1972) suggests that entrepreneurial development in (growing) firms is far from smooth, but instead goes through a series of managerial crises. These crises can be seen as defining learning events. Executive entrepreneurs’ ability to learn from them will determine the successful transition to a further period of growth. Hence one of the areas in which we would expect the external directors to have a role would be in discussing problems and discussing solutions to problems. Both of these actions were rated in the top six (see the Appendix) roles as perceived by the entrepreneurs. Quite often entrepreneurs found a previous event/problem as the best way to describe the role and function of the external director. This happened for example with technology-based firms where the problem may have related to development and marketing of a technology-related product. For example, the following comments concerns the role of an external director in a technology-based firm:

. . . the earlier years was getting the product right . . . its taken years to get the product, market and distribution right (Case 14).

It can also be argued at external directors take an important independence role in family firms and help the firm to overcome issues that would otherwise be dominated by family issues. This same case was also a family firm. The executive entrepreneur considered that family succession issues were:

. . . the critical issue as far as this business is concerned.

Executives in other companies discussed the role of external director as a balance and resolving family conflict where this existed.

Conclusions

In small companies, there is great pressure placed on the entrepreneur as the sole decision maker. Having external or non-executive directors can deflect some of that responsibility. This leads to improved procedures and better decision making as a result. However the external director/mentor is appointed, entrepreneurs in small companies valued the ability to call on an external director to ease the isolation and responsibility of decision making. While the roles of external directors in large firms are comparatively well defined, the limited literature and research on the roles and influence of such directors in small companies still remains a research gap in the entrepreneurial literature. In this paper, we have discussed a number of potential roles that external directors may take in entrepreneurial small companies and compared these to our findings. There are some conclusions that can be drawn about value-added of external directors and their impact on entrepreneurial learning.

Overall, we found that external directors (or NEDs) do bring value-added benefits to a growing small company. Even when appointed as the result of venture capital, such external directors do perform more than mere monitoring functions. Our findings are consistent with those of the Rosenstein (1988) study which suggests that the most important roles and functions of external directors in small, entrepreneurial firms are those which focus on the role of an external director as a counsellor ± guiding and advising the entrepreneur, providing advice on important strategic decisions and taking an important role in the strategic planning processes of the firm. We find less importance than other studies for the impact on networking abilities of the entrepreneur even when the director is VC-appointed. In fact we found this function was highly variable, an important function for some firms, but of very little importance for others. We found greater impact on strategic planning than previous studies, although, as indicated in the discussion of the findings, such a result had been suggested for smaller, entrepreneurial companies by Bygrave and Timmons (1986).

We believe, however, that the impact of external directors in small companies on entrepreneurial learning has been ignored by
previous studies. The build up of trust between the entrepreneur and external director allows the external director to influence decision making in the small company through this developing relationship. This is not achieved through direct intervention, rather through influence on entrepreneurial learning. We have shown that external directors can have an influence upon critical events, on learning through setting challenges and through modification of entrepreneurial behaviour. This impact on learning has not been recognised by previous studies and is one that deserves greater attention.

The fact that we are reporting entrepreneurs’ perceived views is a recognised limitation of the study; it would be desirable to compare such views on value-added with the external directors’ own views through additional face to face interviews. The authors are currently engaged in extending the study by completing interviews from a database of external directors used by selected companies from the first stage. This will not only validate the findings but enable us to compare perceived views of impact.

References


Kline, P. and Saunders, B. (1993), Ten Steps to a Learning Organisation, Great Ocean, VA.


Appendix. Most important and least important roles undertaken by external directors

Table AI

<table>
<thead>
<tr>
<th>Action</th>
<th>Rank order</th>
<th>Perceived importance by mean score</th>
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<tbody>
<tr>
<td><strong>Most important</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Guidance and support</td>
<td>1</td>
<td>3.8</td>
</tr>
<tr>
<td>Discussing problems</td>
<td>2</td>
<td>3.7</td>
</tr>
<tr>
<td>Constructive criticism</td>
<td>3</td>
<td>3.6</td>
</tr>
<tr>
<td>Discussing alternative solutions to problems</td>
<td>4</td>
<td>3.5</td>
</tr>
<tr>
<td>Using benefit or previous (general) experience</td>
<td>5</td>
<td>3.5</td>
</tr>
<tr>
<td>Emotional support</td>
<td>6</td>
<td>3.4</td>
</tr>
<tr>
<td><strong>Least important</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ethical role/action</td>
<td>15</td>
<td>2.3</td>
</tr>
<tr>
<td>Visionary ideas</td>
<td>16</td>
<td>2.0</td>
</tr>
<tr>
<td>Relating concepts to practice</td>
<td>17</td>
<td>2.0</td>
</tr>
<tr>
<td>Succession planning</td>
<td>18</td>
<td>1.7</td>
</tr>
<tr>
<td>Restructuring board</td>
<td>19</td>
<td>1.3</td>
</tr>
<tr>
<td>Administration</td>
<td>20</td>
<td>0.9</td>
</tr>
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**Note:** Likert scale used: 0 to 5