Journal of World Business 44 (2009) 94–103

Contents lists available at ScienceDirect

Journal of World Business

journal homepage: www.elsevier.com/locate/jwb

Institutional background as a determinant of boards of directors' internal and external roles: The case of Russia

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ARTICLE INFO

Keywords:
Corporate governance
Board of directors roles
Ownership structure
Russia
Institutional theory
Path dependency

ABSTRACT

This conceptual paper analyses why some companies in Russia give strong weight to the external roles and some to the internal roles of the boards of directors. The institutional background of Russian corporate governance is reviewed, concentrating on the contextual variables of *time of founding*, *ownership type* and *governmental dependency*, which are seen to explain the varying weight given to internal and external board roles. After arriving at several propositions, the paper finishes with suggestions for an empirical evaluation of the proposed relationships and addresses several managerial implications that stem from the discussion. This paper addresses the under-researched field of contingencies in board roles, focusing on Russia and emphasizing the importance of the prevailing institutional framework in transition economies.

"Weaker state institutions, greater concentration of ownership of firms, more extensive reliance on minority ownership by the state, and a greater reliance on internal finance for investment capital in transition economies suggest that owners and managers may face some different corporate governance problems than their counterparts in more developed economies" (Frye, 2003).

1. Introduction

Effective governance is critical to all economic transactions, especially in emerging and transitional economies (Dharwadkar, George, & Brandes, 2000). Corporate governance mechanisms in Russia are especially interesting, as they are the result of a large-scale institutional experiment performed by the Russian government in the early 1990s with the vigorous support of international financial institutions (Yakovlev, 2004). Today, Russian organisations are encouraged to pay attention to the newly developing market economy and corporate governance systems by means of a well-functioning board of directors, in order to attract much needed domestic and international investments (McCarthy & Puffer, 2008; McCarthy, Puffer, Vikhanski, & Naumov, 2005; Peng, Buck, & Filatochev, 2003; Puffer & McCarthy, 2007).

Previous research has focused on the so-called "usual suspects" in Russian corporate governance, such as the size of the board, the insider-to-outsider ratio, CEO duality, directors' share ownership (see e.g., Dolgopyatova, 2004). Important studies were also conducted on the Russian institutional context and the performance of Russian companies (Dolgopyatova, 2004; Judge, Naoumova, & Koutzevol, 2003; Puffer & McCarthy, 2007). Less attention has been paid to the question of why companies differ in terms of the roles played by their boards of directors.

Researching board roles may offer important insights into Russian corporate governance and its development overtime. Russian companies exhibit different levels of environmental dependency. Compared to more recently founded companies, an older enterprise with strong roots in the planned economy is still likely to prefer, due to a certain amount of organisational inertia (Scott, 1995;

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doi:10.1016/j.jwb.2008.03.011

Stinchcombe, 1965), a reliance on well-established networks within the external environment. External networks have been historically very important in Russia, creating a pervasive network economy in the Soviet era that is still an important part of society today (McCarthy & Puffer, 2008; Puffer & McCarthy, 2007).

When studying the companies' responses to institutional transitions, scholars have concentrated on variations within and across industries, assuming for the most part a relatively stable institutional environment (Peng, 2003). The institutional setting of a transition economy is different and is subject to large-scale institutional transitions on a national level. Apart from company or industry characteristics, the board roles are also contingent on Russia's turbulent transition environment. The conventional board role split into three areas – that of strategy, control, and service (see e.g., Zahra & Pearce, 1989) – may not be enough to capture the companies' strategic responses to institutional changes. This paper proposes to split the board roles rather into internal and external, to better reflect any transitional institutional imbalances, the pervasiveness of the network economy, the varying degrees of environmental dependency and differences in ownership parameters. This may help portray the inherently different approaches to corporate governance in Russia and help researchers avoid potential misjudgements arising from benchmarking the board roles of Russian companies against the conventional split of board roles in Western companies (see e.g., McCarthy & Puffer, 2008).

Emphasis on a board's external roles means the main strategic arena is seen to lie in the company's external environment. They are concerned with obtaining resources, environment co-optation and stakeholder relations. Emphasis on a board's internal roles means the main strategic arena is seen to lie within the company, focusing on strategic participation, managerial control and performance evaluation, as well as providing advice and assistance to managers.

The aim of this paper is to analyse the effect of the Russian institutional framework on the board roles in Russian companies. This paper attempts to answer the question of why history matters to Russian corporate governance, why in this context it is important to differentiate between a board's internal and external roles, and most importantly how the board's internal and external roles vary according to company contingencies of the time of founding, ownership type and governmental dependency. This paper enhances the understanding of Russian corporate governance by drawing on several theories to analyse Russian corporate boards, thus shedding light on corporate governance in heterogeneous transition economies.

The paper is structured as follows. First, the paper draws on institutional theory and path dependency to portray the prevailing network economy in Russia. Then, the boards' internal and external roles are defined on the basis of the Russian institutional framework and corporate governance theories, followed by a number of empirically testable propositions. The paper concludes with discussion of the proposed relationships, followed by implications for managers, and finally further suggestions for research.

2. Institutionalisation of Russian corporate governance

Transitional economies are often facing such a turbulent environment that institutions from both the former planned economy and the emerging market economy are coexisting in the same country at the same time (see e.g., Peng & Heath, 1996). Consequently, companies may see their boards' strategic arenas differently, depending on whether they are facing, for example, agency challenges due to external ownership or challenges related to a high extent of environmental dependency, inherited from a command economy.

An open question that remains is whether such differences may create two partly parallel systems of corporate governance in Russia. The first system may be broadly described as more institutionally embedded, with the emphasis on the board exercising predominantly external roles. The second system embodies a new, Western-inspired approach that puts the emphasis on a board's internal roles. Although the new system is not yet fully embedded into the national context, the internal role seems to be developing for many Russian companies (McCarthy & Puffer, 2008). Due to their path dependency and strong embeddedness within Russia's network economy, some companies may be less affected by market economy forces brought about by the transition process.

The development of corporate governance has proved to be difficult for many Russian companies. The implementation of the corporate governance code of conduct, developed according to Western corporate governance standards, has varied across companies (see e.g., Judge & Naoumova, 2004; McCarthy & Puffer, 2008; Wright, Filatochev, Buck, & Bishop, 2003). The code is in itself a recommendation and many companies have found its implementation difficult or indeed unnecessary. Various studies have reported that outside investors or owners still experience unfair treatment by major owners, in the form of share dilution and transfer pricing, resulting in a lower value for minority shareholders and the company as a whole (Shleifer & Vishny, 1997; Wright et al., 2003).

Elements from both the Anglo-American system of governance (which relies to a large extent on stock markets and managerial markets as control mechanisms) and the continental European system (which relies on boards of directors and legislation as internal control mechanisms) have not been well received in Russia by some companies. It has been argued that this is due to Russia's troubled history, a national culture centred around the state's intervention in business, and existing institutions that negate the rule of law (Judge & Naoumova, 2004). This implies that in the Russian setting, corporate governance will have to adapt its shape and role in order to fit the environment and its institutional context (see e.g., Carlsson, Lundgren, & Olsson, 2000; McCarthy & Puffer, 2002). The changes that are occurring in Russia during the transition process are often institutionally entrenched, as shown by a number of empirical studies (e.g., Puffer & McCarthy, 2007). This phenomenon is consistent with the notion of institutional constraints, which claims that informal institutions may persist even in the face of