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A CASE STUDY ON THE TRANSFER AND TRANSFORMATION PROCESSES OF CORPORATE GOVERNANCE FRAMEWORK

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Pääomasijoittaminen toimii taloudessa kasvun kiihdyttäjänä. Tämä tutkimus on keskittynyt buyout-sijoituksiin tutkimalla eri osapuolien moniulotteisia suhteita ja siihen liittyvää hyvää hallinnointitapaa, joka muodostuu pääomasijoittajan ja yrittäjien välille yrityskaupan aikana ja sen jälkeen pk-kontekstissa. Tutkimuksen tavoitteena on ollut analysoida, miten organisaation epäviralliset rutiinit vaikuttavat hyvän hallinnointitavan siirto- ja muutosprosessiin pääomasijoittajan ostaessa osan yrityksestä. Tehokas riskienhallinta auttaa yrityksiä välttämään taloudellisia vaikeuksia, mutta voi myös parantaa koko yrityksen päätöksentekoa. Hallituksella on keskeinen rooli omistajien ja johdon intressien yhdistämisessä ja riskien hallinnassa. Kohdeyrityksen perhe- tai ei-perheomisteinen tausta lisää pääomasijoittajalle työtä halutun hyvän hallinnointitavan toteuttamiseen. Organisaation muutokseen liittyvät haasteet tulevat yleensä organisaation operatiiviselta tasolta eikä ylimmästä johdosta. Operatiiviselta tasolta tulevien haasteiden lähteeksi on tunnistettu tiedon ja kokemuksen puute sekä uskollisuus vakiintuneille ajattelutavoille. Empiirisen näytön perusteella yrittäjä vaikuttaa voimakkaasti organisaatiokulttuuriin. Organisaatiossa on paljon epävirallisia rutiineja, jotka on otettava huomioon toteuttaessa hyvään hallinnointitapaan tehtäviä muutoksia. Ymmärtämällä hyvän hallinnointitavan käyttöönoton mahdolliset haasteet ja kartoittamalla mahdolliset riskit jo pääomasijoituksen alkuvaiheessa, pääomasijoittaja voi lisätä todennäköisyyttä onnistua yrityskaupassa ja pienentää riskiä sekä halutun hyvän hallinnointitavan siirtoprosessissa että muutosprosessissa.

ABSTRACT

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The private equity industry acts as an accelerator for growth within an economy. This research has been focusing on the buyout investments by taking an inside view by investigating the multifaceted relationship and the related corporate governance framework which builds up between the private equity investor and entrepreneurs during and after the acquisition process in a SME context. The aim of the research has been to analyse how an organisation's informal routines embedded within the portfolio companies impact to transfer and transformation processes of a corporate governance framework when a private equity investor takes over the company. The research has been conducted by investigating how were the organisation's informal routines related to corporate governance were identified and mapped in the due diligence phase and what potential discrepancies emerged between preferred formal principles and actual ones in place at the acquired companies during the transfer and transformation processes. Effective risk management helps companies to avoid costly financial distress but can also improve company-wide decision making. The corporate governance framework and especially the board of directors plays a central role when aligning the interests of owners and management and managing risks with an overall target to increase the company's value. A family-ownership versus non-family-ownership background of the portfolio company causes more work for the private equity investor to educate and bring overall awareness about the best corporate governance practices and establishing a foundation for a corporate governance system. The challenges identified in relation to organisation change usually come from the operative level of the organisation, not from the management. The source of challenges at the operative level has been identified to be a lack of knowledge and experience, and mental allegiance to established ways of thinking. Based on the empirical evidence, the organisational culture is heavily impacted by the entrepreneur. Lots of informal routines are embedded within an organisation which need to be considered. By understanding the possible challenges of implementing a corporate governance framework and mapping out the possible risks already in the due diligence phase, a private equity investor can increase the probability of succeeding in the takeover and mitigate risk in both the transfer and transformation processes.

TABLE OF CONTENTS

1 Introduction 3

1.1 Background for the research 3

1.2 Aim of the research 6

1.3 About the case companies 7

1.4 Research approach and method 8

1.5 Progression of the research 11

2 Change in organisational practices through the lens of institutional theory 12

2.1 Organisational change is a process, not an outcome 12

2.2 The process of institutionalisation 13

2.3 Transfer and transformation processes of organisational change 15

3 Private equity as an accelerator of change 17

3.1 Introduction to private equity investments 17

3.2 Investment process in leveraged buyouts 20

3.3 Valuation process in leveraged buyouts 22

3.4 Takeover process in leveraged buyouts 23

3.5 Cultural and human due diligence 24

4 Corporate governance in an unlisted company 27

4.1 Corporate governance principles in a SME context 27

4.2 Composition and work charter of the board of directors 28

4.3 Remuneration schemes 31

4.4 Internal control and risk management 32

5 Empirical findings 35

5.1 Characteristics of the investment process in Sigma 35

5.2 Case Pi 38

5.3 Case Rho ... 44

6 Concluding remarks ... 48

6.1 Summary of the study ... 48

6.2 Conclusions ... 54

6.3 Ideas for further research ... 57

7 References ... 59

Appendices

Appendix 1: Interviews

Appendix 3: Theme interview questions for the private equity firm

Appendix 4: Theme interview questions for the portfolio company

1 INTRODUCTION

1.1 Background for the research

The private equity industry acts as an accelerator for growth within an economy. Based on an impact study conducted in Finland between the years 2010–2019, the revenue of companies owned by private equity investors has grown by an average of 51.2 percent each year during the first three years of ownership versus a 5.6 percent growth in the control group. Also, the number of employees in companies owned by private equity investors increased by an average of 20.0 percent per year versus a 4.8 percent growth in the control group. (Finnish Venture Capital Association 15.6.2021, 4.) The results of the impact study confirm the important role which the private equity industry has in the growth narrative. In the bigger picture, the private equity industry is creating opportunities for entrepreneurs who need options, either by growing the company together as a joint investment or offering an exit opportunity for the entrepreneur.

The private equity industry aims to reduce barriers of growth experienced by Finnish companies. Barriers to growth within Finnish companies can be traced back to a high level of risk aversion and weak ambition to penetrate to international markets. Clear evidence of this is the small number of medium-sized and truly global companies coming from Finland. Therefore, private equity investors play a significant role in the national economy by helping companies grow and internationalise, commercialise innovation, and reform traditional industries. (Finnish Venture Capital Association 15.6.2021, 5.)

According to the FVCA definition (Finnish Venture Capital Association 15.6.2021, 5), private equity investors are active and temporary growth-oriented owners in unlisted startups and growth companies which, in addition to capital, provide expertise, experience, and extensive networks to support the growth of portfolio companies. Private equity investors can be divided into two groups, which are venture capital investors and buyout investors. A venture capital investor invests in startups at different growth stages and becomes a minority owner, whereas a buyout investor makes investments in more established growth companies and usually takes controlling stake of the company. (Finnish Venture Capital Association 15.6.2021, 5.) This

research focuses on the buyout investments, and we will leave the startup investments out of the scope of this research.

Domestic and foreign buyout investors have invested 4.4 billion euros in Finnish growth companies during the five years of 2016–2020, out of which more than ninety percent of the investments made by Finnish buyout investors have been directed at Finnish growth companies (Finnish Venture Capital Association 15.6.2021, 3). The market review statistic clearly shows the high amount of capital channelled into the Finnish economy in the form of buyout investments. It is also important to highlight the fact that almost all the buyout activity of domestic investors is focused on Finnish growth companies. One explanation for this might be the information advantage over the foreign investors when screening the potential target companies.

A private equity investor usually implements a robust corporate governance framework in the target companies after the transaction is completed. According to the OECD definition (OECD 2015, 9), corporate governance provides a structure through which the objectives of the company are set. This practically means setting up a governance framework for attaining objectives and monitoring performance. A corporate governance framework interacts between a company's management, board, shareholders and other stakeholders (OECD 2015, 9). By appointing external board members, a company can establish more independent practices and improve its internal control systems, which can result in more accountability and better risk management. Small and medium-sized enterprises (SMEs) with a good corporate governance track record can also attract additional funding from investors as well as prepare the company for a possible initial public offering (IPO). (Mahzan, N. & Yan, C. 2014, 160–161.)

In the OECD guidelines for corporate governance, emphasis is placed more on the external view as it covers, for example, topics from the rights and equitable treatment of shareholders to disclosure and transparency. In this research, we are taking an inside view by investigating the multifaceted relationship and the related corporate governance framework which builds up between the private equity investor and entrepreneurs during and after the acquisition process in a SME context.

Mahzan & Yan (2014, 165) argue that SMEs do not necessarily benefit from applying the same corporate governance framework as listed companies. They found that a custom-made framework may be more beneficial for SMEs. A corporate governance framework should be flexible and dynamic. This is a similar approach as there are specific IFRS standards for SMEs. (Mahzan, N. & Yan, C. 2014, 165.)

Most SMEs do not have separation of ownership and management as opposed to larger firms (Mahzan, N. & Yan, C. 2014, 160). This is especially visible in the organisational culture which is primarily driven by the entrepreneur's ethos and motives. Lots of informal routines are embedded within an organisation which will affect the execution of planned activities, and hence the level of robustness of the corporate governance altogether. In the worst-case scenario, a private equity investor is overconfident of the potential embedded interorganisational risks, and the valuation exceeds the true intrinsic value of the target company.

Due diligence collects necessary inputs to decide whether or not to move forward with the transaction (Sharma & Prashar, 2015, 295). A private equity investor usually makes a business plan during the due diligence process. Part of this business plan is the corporate governance framework which will be set up to facilitate and follow up the performance of the acquired portfolio company. Due diligence in a private equity investment is important because it formulates an opinion about the transaction and can potentially save money by revealing risks embedded inside the target firm. The objective of due diligence is to provide greater assurance that the value of the investment will materialise. (Baker, Filbeck & Kiymaz 2015, 11.)

By shedding light on the possible challenges of implementing a corporate governance framework and mapping out the possible risks already during the due diligence phase, a private equity investor increases the probability of succeeding in the takeover. By avoiding overpaying of the target company and minimising negative deviations from the business plan after the transaction is completed, the private equity investor can increase the odds of a successful investment. Due diligence is not an isolated step but should be integrated throughout the investment process (Baker, Filbeck & Kiymaz 2015, 11).

1.2 Aim of the research

This research aims to uncover if the preferred formal practices related to corporate governance evolve into informal action when a private equity firm takes over a company previously owned by an entrepreneur or a group of entrepreneurs. Change in formal principles and procedures does not automatically evoke preferred compliance within an organisation. This is especially evident if there are strong informal routines in place to guide the daily activities within the portfolio company. Based on the empirical setting unfolded here, this research aims to investigate the transfer and transformation processes of a corporate governance framework materialise. Enforcement of formal principles and procedures could lead to only ceremonial commitment if the informal routines embedded within the company are not analysed and their possible impact and associated risks identified and mapped in the due diligence phase.

Managing change requires a thorough understanding of the current context of the organisation. This is especially important in relation to established routines and institutions. The process of change is shaped by a combination of random, systematic and inertial forces, which together create the context out of which new practices emerge. The process of organisational change is therefore path dependent, not just a rational selection of optimal procedures and techniques. (Burns & Scapens 2000, 13.)

The aim of the research is to analyse how an organisation's informal routines embedded within the portfolio company impact the transfer and transformation processes of a corporate governance framework when a private equity investor takes over the company. The transfer refers to actual plans and concrete action to transfer the preferred corporate governance framework from a private equity investor to the portfolio company. The transformation process refers to the changes in the behaviour in the portfolio company which will either materialise or not based on the planned transfer process. The research purpose will guide the following questions, which have directed the empirical analysis.

- How are the organisation's informal routines related to corporate governance identified and mapped in the due diligence phase?

- What potential discrepancies emerge between preferred formal principles and actual ones in place at the acquired companies during the transfer and transformation processes?

Having access to a suitable research setting, we can accumulate empirical data for enhancing knowledge of the behavioural factors affecting buyout investments in a SME context. By shedding light on the possible challenges and mapping out the possible risks, we are also able to enhance prior knowledge of transfer and transformation processes of organisational practices. This will give concrete valuable insights for a private equity investor aiming at realising the full potential of the acquired company, and, even more importantly, integrate this type of behavioural analysis as part of the due diligence process before the actual takeover to mitigate risks.

1.3 About the case companies

The case companies include three entities, which are Pi, Rho and Sigma. Pi and Rho are the portfolio companies and Sigma is the private equity firm which has invested funds into Pi and Rho. In the following text, the backgrounds of the portfolio companies are briefly explained. At the end of the chapter, the background of the private equity firm is also disclosed. The names of the portfolio companies and the private equity firm have been changed so as not to reveal them.

Pi is operating in the logistic industry and has an eight-digit turnover and a staff of a couple hundred. We can categorise it as a SME company with a strong traditional family-ownership background. Sigma has been an investor in Pi for less than five years now. The main motivation for Pi to join forces with Sigma was funding needs and expertise for strategy formulation and business development.

Rho is a business spin-off operating in the software industry and has a seven-digit turnover and a staff of less than one hundred. We can categorise Rho as a SME company which doesn't have a traditional family-ownership background. Sigma has been an investor in Pi for less than ten years now. The main motivation for Rho to join forces with Sigma was funding needs,

accelerating business development, and boosting commercialisation of their service concept and growth in international markets.

Sigma is a private equity company that finances already mature profitable SME companies. It is a growth-oriented company that offers business financing and development that combines active investment and strategic business support. Sigma supports entrepreneurs especially in the development and growth of the company. Entrepreneurs usually continue as owners in the portfolio companies to increase the shareholder value together with Sigma. The financing model of Sigma can be used to organise the ownership structure of the company and align the interests of Sigma and the entrepreneurs in the most ideal way for both parties.

1.4 Research approach and method

This research can be classified as a qualitative case study. In qualitative research, the researcher collects empirical data directly from the field through interviews and observing the social construction where the actors operate (Kasanen et al. 1993, 254). In case research, a small number of research objects are studied in their real-life contexts. The researcher collects empirical data in multiple ways that support each other. The research questions are based on empirical work and driven by interesting theoretical issues. A case study can provide fresh angles, perceptions, interpretations, or solutions to the issues studied and add to prior understanding of the phenomena in question. (Lukka 2005, 375–376.)

The methodological discussion in management studies in the field of accounting has adopted a typology consisting of five approaches. The established research approaches are (Kasanen et al. 1993, 256–257):

- conceptual approach,
- decision-oriented approach,
- nomothetical approach,
- action-oriented approach, and
- constructive approach.

These approaches are located on two axes which are theoretical-empirical and descriptive-normative, separated by their characteristic features (Kasanen et al. 1993, 256–257).

The scientific approach chosen needs to align with the aim and realisation of a case study, and the nature of its results. An action-oriented approach's aim is to achieve a profound understanding of management actions, and it works well in management studies with a practical orientation. (Pihlanto 1994, 370.) Action-oriented research observes the behaviour of people in their real-life contexts and tries to understand the actor's aims and intentions, which have a crucial role in explaining their actions (Pihlanto 1994, 373).

> *"…, the role of the actor interviewed or observed is crucial, because the actor is both a creator and an interpreter of the world and inseparably intertwined with the world and knowledge about it (Pihlanto 1994, 381)."*

This research is a case study carried out in line with the action-oriented approach. The essence of the research is to examine the transfer and transformation processes of a governance framework in portfolio companies during the due diligence and takeover processes of the private equity investor. The portfolio companies are similar in size to the operations being categorised as SMEs but different in respect to their ownership background before Sigma's investment. Pi has a strong family-ownership background, where the ownership was concentrated to a single entrepreneur before the transaction with Sigma. On the other hand, Rho comes from a background where the management, who had previously worked in a multinational listed company, owned the company before Sigma's investment. This will give us a unique research setting to find out if the embedded informal routines and institutions are stronger and stickier in Pi's context compared to Rho, and if this family-ownership background has a material impact on the transfer and transformation processes. Despite the differences mentioned, both portfolio companies are similar with respect to Sigma's ambition to enhance the value of the portfolio companies by establishing a functional corporate governance framework. The action-oriented approach highlights the essential role of the actors interviewed and observed in understanding the nature of transfer and transformation processes of a corporate governance framework.

Lukka (2005, 383) proposes an approach for mapping case studies on two analytical dimensions, which are the nature of the researcher's empirical intervention and the theory

linkage of the study. The non-interventionist case studies are theory discovery case research, theory illustration case research, theory refinement case research and theory testing case research. Interventionist case studies include action case research and constructive case research. (Lukka 2005, 383.) Prior attempts aimed at mapping case research include Scapens' (1990, 265) classification between the descriptive case research, the illustrative case research, the experimental case research, the exploratory case research and the explanatory case research.

The starting point for theory illustration case research is a certain existing theory from outside the domain of finance. Empirical findings are interpreted based on the selected theory frame and the conceptual system and vocabulary and causality claims of the underlying theory are used in the research. (Lukka 2005, 384–385.) The descriptive case research describes practices and compares their emerging variations (Scapens 1990, 265).

According to Lukka's (2005) classification, this research will be classified as theory illustration case research. The institutional theory will be mobilised as a method theory, and its conceptual framework concerning the relationships between institutions and routines is utilised in the research. The researcher's empirical intervention is kept at a low level, merely describing and interpreting the due diligence process and corporate governance framework in place and comparing discrepancies between preferred practices and the actual outcome at the portfolio companies. According to Scapens' (1990) classification, our research will be classified as descriptive case research.

There are three different interview types, which are structured form interview, unstructured interview, and theme interview. These interview types are different with respect to the level of structure. The level of structure means the flexibility of the interview questions and how the interview situation complies with the preliminary research agenda. (Hirsjärvi and Hurme 2010, 43–48.) The theme interview structure is the same for all the interviewees, but the form and the sequence of the questions can be modified depending on the interview situation and the flow of the interview. A fundamental part of the theme interview are the interpretations and meanings given by the interviewees on the research phenomena. (Hirsjärvi and Hurme 2010, 47–48.)

Theme interviews provide a view into the case companies together with the researcher's own observations on activities in the natural context in which they take place. The interviews have been conducted over a period of eight months during which the processes of transfer and transformation had already been in motion for multiple years. Access to Pi and Rho was gained through a contact from Sigma, and the researcher was given the freedom to interview anyone he wished at the portfolio companies. The data under analysis consists of archival and current written materials from the case companies and recorded interviews conducted on-site.

The theme interviews enable access to various narratives through which people describe their world. With this approach, we abandon the attempt to treat the respondents' answers as true pictures of reality and factual statements of the surrounding world. The idea is to see the respondents' answers as cultural stories which highlight the interviewee's personal view of the real-life context. (Silverman 2005, 154–157.) Empirical data from the case companies was organised in narratives depicting the transfer and transformation processes of the corporate governance framework. The transfer and transformation processes of the corporate governance framework were then analysed through the meanings and interpretations given by the interviewees in accordance with the action-oriented research approach.

1.5 Progression of the research

Chapter 2 introduces the institutional theory's view in relation to change in organisational practices. It presents a meta-level conceptual framework and a lens for analysing the substantive issues under examination. Three dichotomies for classifying and distinguishing between different types of change processes are presented in accordance with challenges to change.

Chapter 3 presents the structure and operating model of a leveraged buyout (LBO) fund. It also takes a closer look at the investment process from the beginning to the end and highlights motives to integrate corporate-governance-framework-related due diligence as part of the investment process. Chapter 4 covers generally accepted corporate governance guidelines and principles for SME companies and lists practical examples in the context of this research.

In Chapter 5, the empirical findings are presented in accordance with the aim of the research. Chapter 6 presents concluding remarks and recommendations for further research.

2 CHANGE IN ORGANISATIONAL PRACTICES THROUGH THE LENS OF INSTITUTIONAL THEORY

2.1 Organisational change is a process, not an outcome

This research concentrates on understanding why and how organisational practices evolve over time. Burns and Scapens' (2000) research on organisational change focuses on change as a process rather than an outcome. Although the framework comes from the domain of management accounting, the framework is equally relevant for conceptualising processes of change in other organisational activities. (Burns & Scapens 2000, 4.)

Organisational practices can both shape and be shaped by the institutions which exist in the organisation (Burns & Scapens 2000, 5). An institution is defined as shared taken-for-granted assumptions that identify appropriate activities and relationships among a group of people (Burns & Scapens 2000, 8). Key concepts are the relationship between formal rules and informal routines. Rules are defined as the formally recognised way in which things should be done. They are necessary to co-ordinate and give coherence to the actions of groups of individuals. Routines are defined as the way in which things are actually done. They represent the habits of the group of informal practices actually in use. (Burns & Scapens 2000, 6.)

Rules and routines can be identified and mapped to belonging to a specific historical context. Institutions, on the other hand, are disassociated from their specific historical context, and they exist only in the minds of people and express the way things are. Institutions are socially constructed and created by the people themselves. They are taken-for-granted assumptions which inform and shape the activities of individual actors. (Burns & Scapens 2000, 7-8.)

After formal rules are established, through their implementation, informal routines will emerge. This happens when previously formulated rules are modified as the group finds mutually acceptable ways of implementing them. The process could also be reversed. Newly established

informal routines, which deviated from the original formal rules, could be formalised as a new set of formal rules. Rules are typically changed at a specific point in time, but routines are in a cumulative process of change as they are continuously being reproduced (Burns & Scapens 2000, 6-7).

In the context of the transfer and transformation processes of a corporate governance framework, rules depict the formal rules as governance principles are introduced into the portfolio companies, whereas routines depict the informal activities where the members of the organisation are adapting to a new situation by developing and adjusting the ways of operating in the portfolio company.

2.2 The process of institutionalisation

Burns and Scapens (2000) have further developed Barley and Tolbert's (1997) institutional framework for studying organisational change. The purpose of the framework is to describe and explain analytical concepts, which can be used for interpretive case studies. In Figure 1, the process of institutionalisation is divided into different elements and four processes (a, b, c and d) which are explained in the following sections. (Burns and Scapens 2000, 9.)

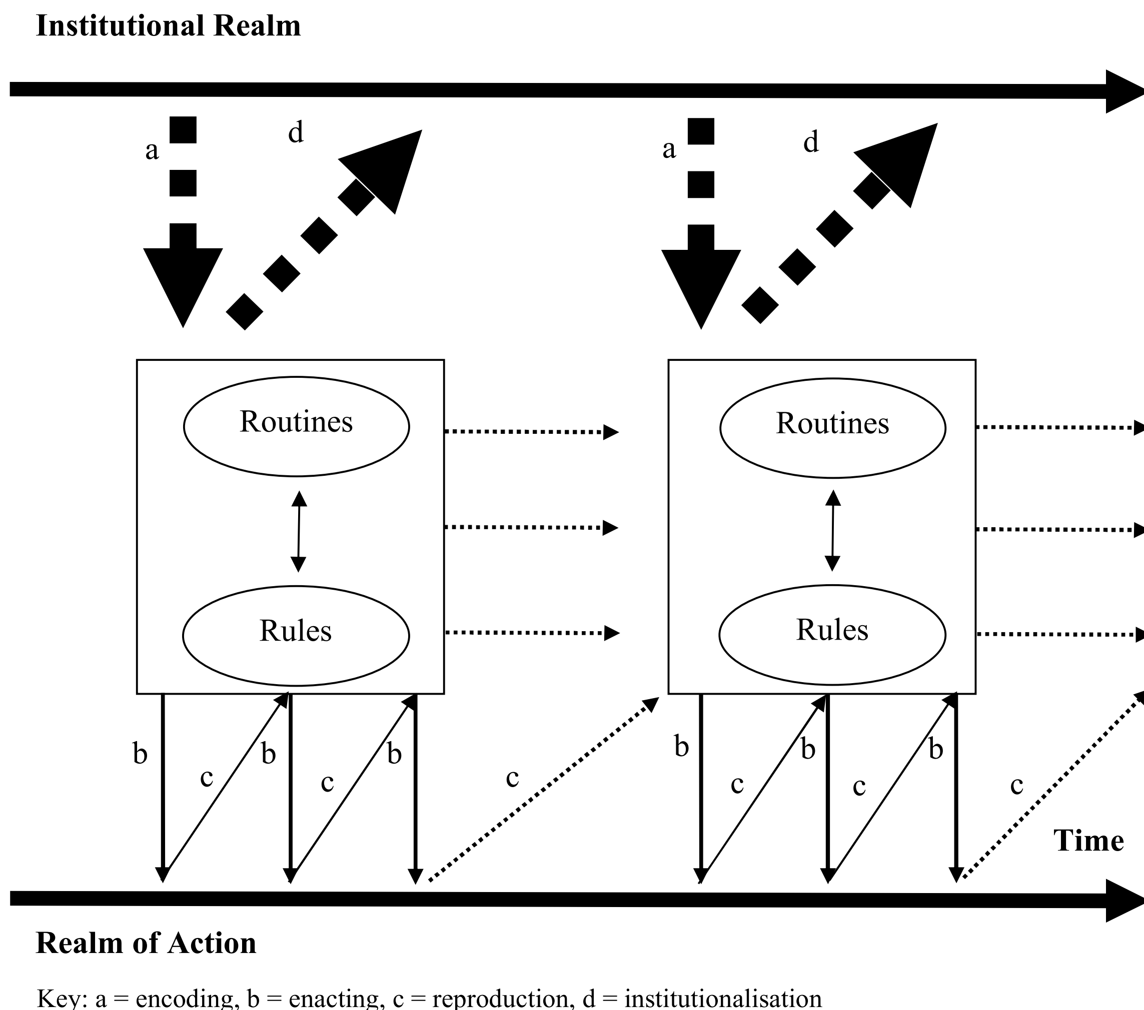

Figure 1. The process of institutionalisation (Burns & Scapens 2000, 9)

Institutions constrain and shape action at a specific point in time. Actions, on the other hand, produce and reproduce institutions through their cumulative influence over time. Both the institutional realm and the realm of action are in constant ongoing cumulative processes of change through time. The change process in the institutional realm occurs over a long period of time, whereas new rules and new routines may be introduced in a more discreet way from time to time. This is illustrated in Figure 1 by the separate boxes in the middle. (Burns & Scapens 2000, 9–10.)

The encoding process (a) tries to transfer new institutional principles into modified rules and routines. The current existing routines and rules represent the prevailing institutional principles which shape new routines and rules when the encoding process evolves through time. In the

enacting process (b), people will adjust their routines and rules to include the new institutional principles either consciously or unconsciously. The process of enactment (b) may be subject to resistance if the new routines and rules challenge existing meanings and values, and people have sufficient resources of power to intervene in this process. (Burns & Scapens 2000, 10–11.)

The reproduction process (c) happens as repeated behaviour leads to reiteration of routines and rules. The reproduction process (c) may involve either conscious or unintended change. Conscious change occurs only if actors collectively question the current prevailing routines and rules, whereas unintended change occurs in the absence of a system to monitor change. Change in routines and rules in the case of unintended change means that those are not sufficiently understood and therefore accepted by the actors. When routines and rules have been reproduced through the behaviour of people, the process of institutionalisation (d) happens. Routines and rules become institutions by cumulative processes of change through time. (Burns & Scapens 2000, 10–11.)

2.3 Transfer and transformation processes of organisational change

It is important to examine the existing institutions when studying specific intentional change. The existing institutions shape the process of change because they exist prior to any attempt to introduce change. The intended formal rules may become modified as acceptable modes of behaviour emerge. What is deemed acceptable is influenced by the importance of existing informal routines and the power of individual actors within an organisation. The processes of change may result in new routines which over time evolve and become institutionalised. (Burns & Scapens 2000, 11–12.)

Organisational change that is consistent with the existing routines and institutions is easier to achieve than change that challenges them. Change that conflicts with existing routines and institutions is more difficult to implement. (Burns & Scapens 2000, 12.) Resistance to change can be classified into three separate but interrelated elements (Burns & Scapens 2000, 17):

- Formal and open resistance due to competing interests.
- Resistance due to a lack of knowledge and experience to cope with such change.

- Resistance due to a mental allegiance to established ways of thinking and doing, embodied in existing routines and institutions.

Three different characteristics can be utilised to provide ways of classifying and distinguishing between different types of change processes. The first dichotomy is formal versus informal change. Formal change occurs by conscious design, whereas informal change occurs at a more tacit level. The introduction of new rules by a powerful individual or group is an example of formal change, whereas informal change occurs as new routines adapt over time to changing operating conditions. It is important to notice that formal change as a concept is straightforward, and the successful implementation of a formal change should also happen at the conscious level in the people. (Burns & Scapens 2000, 18.)

The second dichotomy is revolutionary versus evolutionary change. Revolutionary change involves a fundamental disruption to existing routines and institutions, whereas evolutionary change is incremental with only minor disruption to existing routines and institutions. Revolutionary change is not related to the particular content of the change but rather to its potential to impact existing routines and institutions. (Burns & Scapens 2000, 20.)

The third dichotomy is regressive versus progressive change, which is also depicted as ceremonial versus instrumental behaviour. Ceremonial behaviour emerges from a value system that discriminates between human beings and preserves existing power structures, whereas instrumental behaviour applies the best available knowledge and technology to problems and seeks to enhance relationships. (Burns & Scapens 2000, 20–21.)

The work environment perceptions influence the way people respond to different situations and their decision-making processes, but those also vary from one individual to another. A private equity firm needs to understand the differences and similarities in different cultures. There are two layers of culture within an organisation, which are organisational culture and national culture. Organisational culture is an informal set of values, norms, and beliefs that control the way people and groups in an organisation interact within and outside the organisation. The decisions that people make in organisations are largely dependent on their values and attitudes, and those are passed on from the older members of the organisation to the younger members.

This will make informal values and attitudes even more permanent in the organisation. Conflicting values can become a challenge at the time the transaction is completed and the transformation process starts, if the two organisations do not have complimentary cultures. (Sharma & Prashar, 2015, 301–302.)

3 PRIVATE EQUITY AS AN ACCELERATOR OF CHANGE

3.1 Introduction to private equity investments

A private equity is an asset class which invests in companies which are not quoted on a public stock exchange. Main types of private equity investments are venture capital, development capital, mezzazine capital, leveraged buyouts (LBOs) and distressed investments. (Seretakis 2015, 34.) In more general terms, what separates different types of private equity investments from each other are the development phase of the portfolio company, and the level and type of financing used.

The private equity industry has a history dating back to the early 20th century, when J.P. Morgan & Company conducted the first formal private equity deal as a leveraged buyout in 1901. Afterwards, thousands of private equity deals have been executed. (Baker, Filbeck & Kiymaz 2015 15.) Private equity funds first emerged in the early 1980s (Kaplan & Strömberg 2009, 125). Global private equity and venture capital assets under management (AUM) have increased by 6.1% from the end of 2019 to 4.74 trillion USD as of June 2020. The growth rate was lower than the 9.9% average of the past decade, but growth is estimated to accelerate toward an AUM of 9.11 trillion USD in 2025. (Preqin 4.2.2021, 12.) In Finland, the private equity industry has an important role as an incubator for IPOs in the Helsinki stock exchange. About 50 percent of the Finnish companies listed on the stock exchange during 2016–2020 have been private equity backed companies. (Finnish Venture Capital Association 15.6.2021, 6.)

A distinctive difference between a private equity owned firm and another publicly or privately held firm is the use of debt. The firms associated with private equity are highly leveraged, usually taking more than 70 percent of debt. A highly leveraged capital structure benefits from

deductibility of interest expenses when calculating taxable income. (Dutta, Ganguly & Ge, 2015, 17.) On the other hand, high leverage also makes the company vulnerable to solvency-related problems. This setup will higlight the capability to manage incoming and outgoing cash flows and the terms of financing with creditors in general.

A buyout refers to investments in mature companies where a group of investors acquires the portfolio company from the current owners with equity finance from a private equity provider and debt finance from a financial institution (Baker, Filbeck & Kiymaz, 2015, 3.) In a buyout investment, the goal is usually to make a fundamental change in the ways the company is currently operating. This can happen, for example, either by accelerating the growth with better financing opportunities or developing operational efficiency throughout the whole value chain of the company. It is also very common to take both growth and operational efficiency measures simultaneously.

According to Jensen (1989, 65), a LBO business model is built around highly leveraged financial structures, pay-for-performance compensation systems, substantial equity ownership by company executives, and contracts with owners and creditors that limit the waste of free cash flow. Free cash flow here refers to the residual left for the debt and equity holders (i.e., repaying debt and paying out interest and dividends) after necessary capital expenditure has been made.

Private equity firms often make a substantial cultural change in the companies that they manage, which disrupts the normal functioning of such companies and often results in certain inevitable social and economic costs (Dutta, Ganguly & Ge 2015, 18). These social and economic costs usually appear in the mainstream media as layoffs, as the private equity firm pursues a more streamlined organisation. Further investigations into the economic benefit of the private equity industry paint a different picture that contrasts with the negative narratives raised by the mainstream media. Claims that private equity restructures firms to extinction, cashes out short term, destroys jobs, and increases the likelihood of bankruptcy due to high leverage for portfolio companies are not reality, based on the academic evidence. (Dutta, Ganguly & Ge 2015, 18.) The portfolio companies owned by private equity firms are not managed to maximise earnings per share but rather to maximise value via cash flow generation (Jensen 1989, 65.) A cash flow

generation focus often enhances the capability to manage debt levels but also secures the long-term viability of the company and its workforce.

A private equity fund is legally set mainly as a limited partnership in which the general partners manage the fund and the limited partners provide most of the capital. The limited partners are typically corporate and public pension funds, endowments, and insurance companies, as well as wealthy individuals. The private equity firm is the general partner of the fund. (Kaplan & Strömberg 2009, 123.) This basically means that only the general partner is screening the potential firms in which to invest and has active dialogue towards the portfolio companies in which the fund has invested money. Other investors are passive partners with little to no power over how the portfolio companies operate. The private equity firm is usually compensated by an annual management fee, a share of the fund's profits and some monitoring fees (Baker, Filbeck & Kiymaz 2015, 5.) Most private equity funds are closed-end so that investors cannot withdraw their funds until the fund is terminated (Kaplan & Strömberg 2009, 123). Figure 2 illustrates the example structure of a private equity fund.

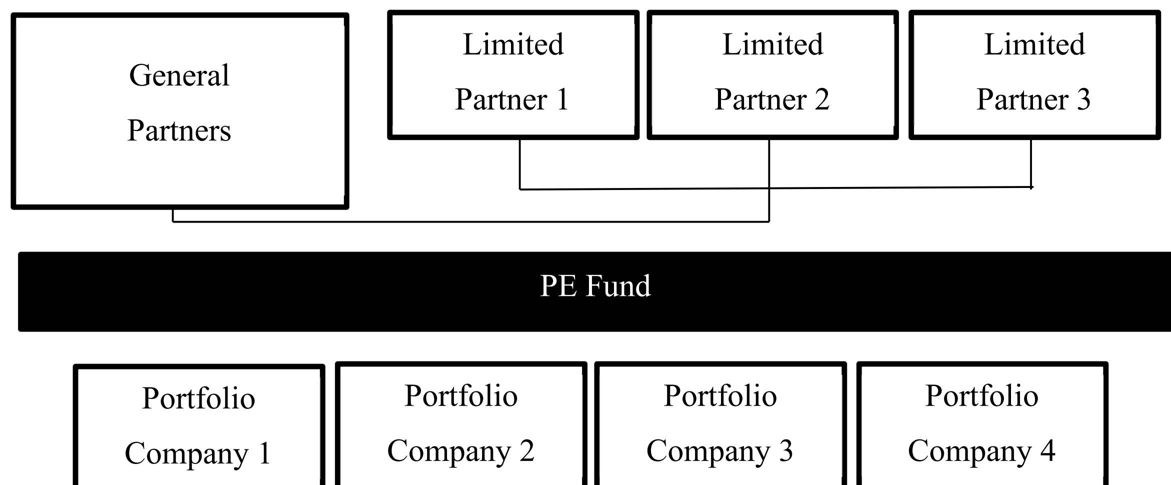

Figure 2. Example structure of a private equity fund (Dutta, Ganguly & Ge 2015, 22)

A private equity fund typically has a fixed life, which is usually ten to thirteen years. The private equity firm normally has up to five years to invest the fund's committed capital into portfolio companies. After initial investment, the private equity fund has an additional five to eight years to return the capital to its investors. (Kaplan & Strömberg 2009, 123.)

The Finnish buy-out market consists of a few minority investment funds and a group of funds who make majority investments. The biggest investor group is pension insurance companies, and the second largest investor group is mutual funds. Family offices have become the third-largest group of fund investors. (Finnish Venture Capital Association 15.6.2021, 6.)

Based on a sample of 17 171 worldwide leveraged buyout transactions between 1970 and 2007, the median holding period is roughly six years, but this has varied over time based on the business cycle, like the active IPO market of the late 1990s (Kaplan & Strömberg 2009, 129). Integrating environmental, social and governance (ESG) principles in the investing process is seen increasingly as a key focus area for the private equity industry. Private equity firms need to start responding to a growing demand from institutional investors to establish ESG compliant funds. (Preqin 4.2.2021, 13.)

3.2 Investment process in leveraged buyouts

A private equity firm tries to identify companies which have potential to generate returns for the investors of the private equity fund. This can happen by providing long-term capital which is used, for example, for funding specific R&D projects, launching new products or services, supporting growth via working capital financing, making acquisitions, strengthening the balance sheet or restructuring underperforming parts of the business (Baker, Filbeck & Kiymaz 2015, 4).

The process for identifying a target company starts by screening multiple potential firms by focusing on the ones that underperform within their peer group in a relatively mature industry. Target companies should have a stable product demand and much unused debt capacity in order to absorb extra borrowing. After identifying a target company which meets the investment criteria, the purchase is financed with debt often borrowing against the target company's assets. (Dutta, Ganguly & Ge 2015, 21.) Figure 3 illustrates the changes in the capital structure during the leveraged buyout process. After the LBO, the capital structure is fundamentally changed. Free cash flow is used for repaying debt so that the targeted debt to equity ratio is met in the exit phase.

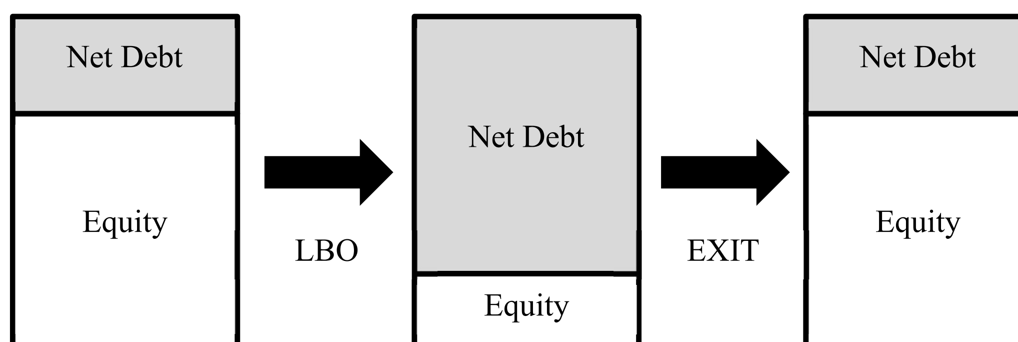

Figure 3. Changes in capital structure in a leveraged buyout process (Dutta, Ganguly & Ge 2015, 21)

The investment process of a private equity firm has three phases, which are pre-investment phase, investment phase and exit phase. The first phase is the pre-investment phase, where the general partner identifies a suitable target company and plans the capital structure for the transaction. In the second phase, the aim is to increase the portfolio company's value and to repay the transaction debt which was used to finance the deal. The final step is the exit phase where the portfolio company is sold. (Rauch & Umber 2015, 73.)

The exit phase is comprised of selling the target company and distributing the proceeds to the private equity investors. There are typically four exit channels, which are a trade sale to a strategic investor, a trade sale to another financial investor, an IPO, or a combination of different exit channels. The most profitable exit strategy is usually to take the portfolio company public via an IPO, compared to other exit strategies. (Rauch & Umber 2015, 77–78.)

The most important out of these three phases is the pre-investment phase, because choosing a suitable portfolio company is critical to the performance of the buyout fund and its ability to raise capital for launching new funds in the future. It can sometimes take years to find suitable target companies and negotiate the terms of the possible acquisition. (Rauch & Umber 2015, 74.)

There are three key factors to consider when screening the target companies. These are economic value creation potential, free cash flow generation capacity and relative valuation. Especially in relation to economic value creation potential, a fund manager is looking for inefficiencies, which are generally rising from overall bad governance structures and the existence of underperforming business divisions. (Rauch & Umber 2015, 74.)

3.3 Valuation process in leveraged buyouts

Cash flow-based valuation models usually build on a few principles, which are identifying cash flows generated by the portfolio company and understanding the riskiness of these cash flows and the cost of capital driven by the capital structure of the company. Other valuation methods include using multiplies-based valuation methods. (Platt & Trahan 2015, 123.)

The pre-investment valuation can be incorrect for several reasons. Sources for mistakes can be, for example, inaccurate cash flow projections, a failure to understand the overall riskiness of the bought company, wrong estimations of macroeconomic factors or an incorrect identification of the company's cost of capital. (Platt & Trahan 2015, 123.)

The starting point in the valuation process is detailed spreadsheets of the portfolio company's income statement and balance sheet. This is the first differentiation point among private equity firms, because each has varying levels of skill in financial modelling, and each has different assumptions about the firm's growth rate, cost structure, and working capital management efficiency. A private equity firm typically incorporates different scenarios of how they might be able to change future cash flows by modelling different revenue-increasing and cost-reducing strategies. (Platt & Trahan 2015, 126.)

After the analytical modelling, the valuation process moves to leverage optimisation, where the level of debt is decided. When combining the analytical modelling and leverage optimisation steps, the private equity firm can estimate the present value of the target company. The present value is then compared to the price of the target company, which then gives the potential return proxy for the investment. (Platt & Trahan 2015, 127.) Figure 4 illustrates the core steps in the private equity valuation process.

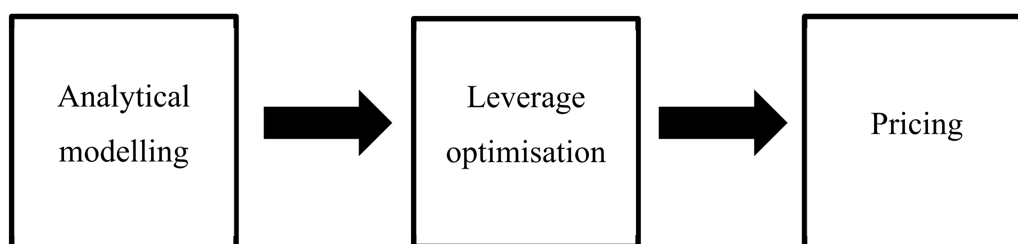

Figure 4. The core steps of the private equity valuation process (Platt & Trahan 2015, 127)

After acquiring a target company, private equity firms try to raise the value of the acquisition. This happens, for example, by hiring restructuring professionals and performing turnaround actions to uplift performance level. A common problem in these efforts is that the employees of the portfolio company may resist change. One way to mitigate this is with coherent incentives that appropriately share the returns from the turnaround with those whose efforts maximise the benefits. (Platt & Trahan 2015, 132.)

3.4 Takeover process in leveraged buyouts

After the investment has been made in the portfolio company, the next step is usually to change the management's incentive structure to provide the management team with incentives to act according to the best interest of the new owners. The general partner of the private equity fund usually also changes the composition of the board of directors. (Baker, Filbeck & Kiymaz 2015, 5.) Private equity owners control the boards of their portfolio companies and are more actively involved in governance. Typically, portfolio company boards are smaller than comparable public company boards and meet more frequently, and do not hesitate to replace poorly performing management. (Kaplan & Strömberg 2009, 131–132.)

There are three distinct categories of restructuring efforts which usually happen after the takeover. These are financial engineering, operational engineering and governance engineering. The first part of financial engineering concentrates on efforts to replace the old capital structure with the acquisition financing structure, where a high amount of debt is used to benefit from tax-deductibility of interest expenses and to increase the value of equity stake by paying down the debt overtime. It is also important to negotiate the desired terms for interest rates and debt covenants to have enough flexibility for restructuring measures, like asset divestments. (Rauch & Umber 2015, 75.)

In the second part of the financial engineering, the financial accounting of the portfolio company is optimised to maximise the enterprise value in the exit phase (Rauch & Umber 2015, 75). The signs of earning management can be detected if there are material changes happening in accounting principles and lots of non-recurring items or discretionary accruals booked, especially near the exit phase of the investment.

Operational engineering concentrates on increasing the top line and lowering the overall cost base to maximise the cash flow from operations. These strategies can involve reducing corporate overhead through layoffs of personnel, a shutdown of unprofitable production lines, a divestment of underperforming divisions, and expanding profitable offering. (Rauch & Umber 2015, 76.)

Governance engineering involves changes in the governance structures of the portfolio company to lower agency costs. To accomplish this, the fund manager selects an optimal management team and aligns the interests of the private equity investors and managers with the ownership stakes in the portfolio company. It is common that the private equity owner holds board seats to closely oversee the managers to make sure that all desired restructuring measures can be fully implemented by the management. (Rauch & Umber 2015, 76.)

Private equity firms also require management to make a material investment in the portfolio company. Because the portfolio company is private, the management cannot sell its equity or exercise its options easily until the value is materialised by an exit. This illiquidity reduces the management's incentive to act in a suboptimal way in the short term. (Kaplan & Strömberg 2009, 131.) The owner-manager conflict resolution is more efficient under private ownership than in a publicly held corporation, because the corporate structure enables motivating the management more thoroughly (Jensen 1989, 65).

3.5 Cultural and human due diligence

Due diligence refers to the process of investigating a potential investment by establishing all material facts about a target company before entering into a transaction. The due diligence

process tries to ensure that the party gets what it expects out of the transaction which it is planning to commit to. (Sharma & Prashar 2015, 290.)

The due diligence process involves four phases, which are planning phase, data collection phase, data analysis phase and report finalisation. The main purpose of the planning phase is to go through technicalities and the scope of the transaction, so that objectives are clarified and the availability and skill set of the transaction team and advisors are secured. The planning phase also offers an initial view on the target company's financials, competition, management team and organisational culture, as well as the sustainability of the business (Sharma & Prashar 2015, 294.)

The data collection phase acquires the key business data that is relevant to the target company. Information is gathered from multiple sources like the internet, competitors, databases, vendors, customers, industry associations, or other relevant stakeholders associated with the company. Data will then be analysed to draw conclusions based on business-critical factors such as the individual strategy of each business function of the company, potential market growth, and regulatory constraints. In the last phase, the final presentations and reports are produced and those will become part of the decision-making and negotiation process. (Sharma & Prashar 2015, 294.)

Figure 5 illustrates ten important types of due diligence areas that should be considered before finalising the transaction (Sharma & Prashar 2015, 296.) Especial focus in this research is concentrated on the human due diligence and cultural due diligence areas. A private equity firm spends a lot of time on collecting financial, operational, and commercial information about the target company and usually ignores people-related matters. Human due diligence focuses on organisational culture and the roles, responsibilities, capabilities, and attitudes of the people in the company. (Sharma & Prashar 2015, 301.)

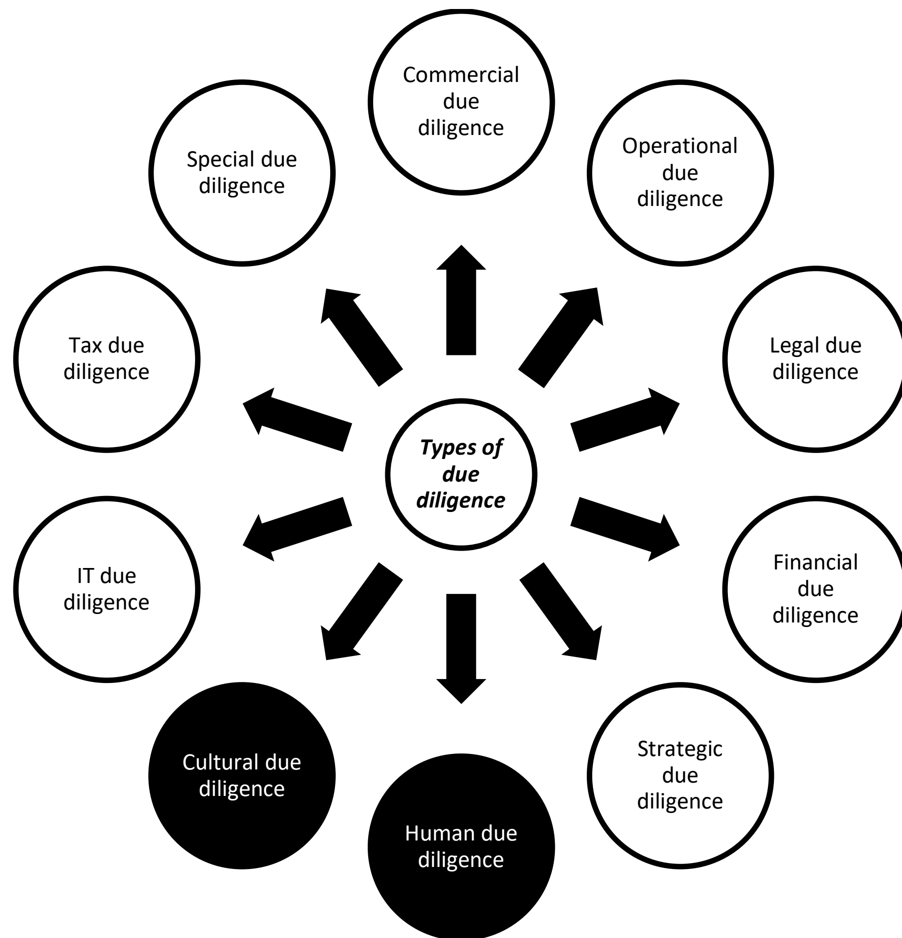

Figure 5. Types of due diligence (Sharma & Prashar 2015, 296)

Cultural due diligence formulates a holistic view of the cultures of different companies during the earliest possible phase of a transaction. If the cultural due diligence reports identify material cultural differences, then a plan should be developed to overcome them. A private equity firm should understand that a transaction involves the confrontation of two different organisational cultures. (Sharma & Prashar 2015, 301.) Cultural due diligence offers insight into the target company's cultural synergies and potential conflicts. While conducting cultural due diligence, the private equity firm should formulate an action plan to improve and change cultural fit after the transaction is finalised. (Sharma & Prashar 2015, 302.) Due diligence helps the private equity firm gain insights into the credibility of the target company's owners and management. After the deal is completed, identifying the appropriate strategic direction is needed to increase performance and increase value. (Sharma & Prashar 2015, 295.)

4 CORPORATE GOVERNANCE IN AN UNLISTED COMPANY

4.1 Corporate governance principles in a SME context

The main purpose for a separate governance code for unlisted companies is to make compliance to the principles more flexible and less bureaucratic compared to their listed counterparts. By having well-thought-out and context-specific corporate governance principles in place, the information exchange improves and makes operations more efficient. A corporate governance framework also improves the credibility of the company and helps to get easier access to financing. (Finland Chamber of Commerce April 2016, 4.) Companies may achieve strategic, tactical and operational efficiency by embracing good corporate governance principles. In practice, the current track record of corporate governance in SMEs is not impressive because of a lack of awareness as well as a high cost associated with implementation. (Mahzan, N. & Yan, C. 2014, 156.)

SMEs should have simpler governance structures compared to larger listed companies and still be able to benefit from having good governance principles in place. SMEs do not necessarily need to have the same corporate governance framework as public listed companies have. (Mahzan, N. & Yan, C. 2014, 161.) The corporate governance recommendations for an unlisted company are divided into the following subcategories by the Finnish Chamber of Commerce guidelines for unlisted companies (Finland Chamber of Commerce April 2016, 4):

- general meeting,
- board of directors,
- managing director,
- remuneration schemes,
- internal control and risk management,
- audit,
- articles of association,
- shareholders’ agreements,
- redemption and approval clauses, and

- communications and information.

The focus will be directed to the board of directors, remuneration schemes, and internal control and risk management due to the selected approach to investigate the inside view of corporate governance, which is set in the aim of the research. Effective risk management helps companies to avoid costly financial distress but can also improve company-wide decision making. The corporate governance framework and especially the board of directors plays a central role when aligning the interests of owners and management and managing risks with an overall target to increase the company's value. The ability of the board to successfully achieve these goals depends largely on its composition and the quality of the working methods. (Gouiaa 2018, 14.) A private equity investor is trying to improve a portfolio company's overall governance structure by more active monitoring exercised by more concentrated ownership, the use of equity-based incentives for top management and having extra pressure from debtors due to high leverage (Dutta, Ganguly & Ge 2015, 26).

4.2 Composition and work charter of the board of directors

In order to execute the business plan, the portfolio company needs to have a board of directors which is capable of leading the portfolio company to the planned targets. The responsibility of the board of directors is described as follows:

> *"The board of directors is responsible for the administration of the company and for the appropriate management of its business. The board guides and supervises the company's operations and its managing director, it appoints and dismisses the managing director, it approves the company's goals and objectives and its risk management principles. The board ensures the appropriate function of the company's management system and is furthermore responsible for the supervision of the company's accounts and the administration of its finances. The duty of the directors is to promote the company's and all its shareholders' interests, irrespective of who has proposed their candidature for board membership." (Finland Chamber of Commerce April 2016, 12.)*

The board of directors is responsible for the identification, evaluation and mitigation of all types of risks such as economic risk, operational risk, market risk and liquidity risk. Therefore, board structure and director characteristics are critical elements for board effectiveness. The structure of the board is related to the size of the board, composition, and established committees. Characteristics include experience, compensation, and financial expertise. Also, the board's operating process matters because it refers to the frequency and attendance of directors at board and committee meetings. (Gouiaa 2018, 15.)

The number of members in the board of directors is driven by the size of the company's business, the dispersion of its ownership base and the nature of its business operations. The right number of directors in the board should ensure effective management and good administration of the company, so that there is enough time for carrying out duties, in addition to the board members' other engagements. The composition of the board also needs to be sufficiently diversified, so that strengths and weaknesses are in a proper balance, and expertise across the board is complementary. The rotation of board seats helps to make sure that the board renews itself and expertise is updated. (Finland Chamber of Commerce April 2016, 12–13.) The effectiveness of the board's oversight increases with its size because of the possibility of distributing the workload to a larger number of members. A larger board helps with more efficient overall control and effective risk management. (Gouiaa 2018, 15.)

By appointing individuals who do not previously have any close relations with the company, a board is able to improve the conduct of business especially for all the shareholders as equal treatment demands (Finland Chamber of Commerce April 2016, 12.) By having external board members, the company will increase the likelihood of more independent decisions when running the business. This will help improve internal control systems, which could potentially result in more accountability and enhanced risk management. (Mahzan, N. & Yan, C. 2014, 160.) Independent directors can potentially reduce excessive risk taking in strategic and operational decisions. This implies a negative relationship between the percentage of independent directors on the board and excessive risk taking by management. (Gouiaa 2018, 15.)

On the other hand, independent board members may underperform in the monitoring role, at least in the beginning, as they do not have a significant financial interest in the company, and therefore have little to gain personally from improvements in the portfolio company's performance. Secondly, independent board members may have a relatively small portion of their time to commit to the portfolio company's affairs on top of their other duties. This is because board members are usually c-level executives and can simultaneously occupy seats in other boards. There is also a risk that an independent board member might owe loyalty to the people who proposed them on the board, so that they are re-elected and are able to continue to collect board fees in the future. (Hart, O. 1995, 682)

The efficiency of the board's work can be improved by regularly evaluating working methods and results achieved. Evaluation can cover, for example (Finland Chamber of Commerce April 2016, 13):

- the internal work distribution of the board and its efficiency,
- the contribution of each director in the board's work or, more precisely, his or her expertise in relation to the company strategy,
- the satisfaction of the board of directors and the need for rotation,
- the operations of the chairman, and
- the chairman's preparations for meetings.

Sufficient and equal information flow across the board of directors is important to establish. This is especially important for the board members who are independent from the company. The chairman of the board has a material impact on the effective fulfilment of board duties and ensuring co-operation between other board members to capture the synergy of different expertise. The relationship between the chairman and the managing director is also essential for the company. (Finland Chamber of Commerce April 2016, 13–14.)

By defining essential duties and operating principles in a written charter, the board can improve operational efficiency. The written charter can contain provisions on the work distribution between the board of directors, the frequency of board meetings, the extent to which deputy directors are involved in the board's work and how the directors are invited to meetings. The planning of the board's work can be facilitated by the use of an annual clock. Efficient meeting

practices also include that board materials are received in advance and on an equal basis, and meeting minutes are prepared after each meeting. (Finland Chamber of Commerce April 2016, 14.) A high frequency of board meetings and a high attendance rate of directors should lead to an improved quality of risk management and a reduction of risk levels (Gouiaa 2018, 17).

4.3 Remuneration schemes

One of the key aspects, especially in the private equity industry, is the role that the remuneration plans play in aligning the interest of owners and a portfolio company's management. Private equity firms require management to make a material investment in the portfolio company, so that the management also has a significant upside and downside embedded in the success of the transaction (Kaplan & Strömberg 2009, 131). The main purpose of the remuneration plan based on the Finnish Chamber of Commerce guidelines for an unlisted company is:

> *"…to promote the company's long-term financial success, competitiveness and the favourable development of shareholder value (Finland Chamber of Commerce April 2016, 18.)"*

The median chief executive officer receives 5.4 percent of the equity while the management team as a total gets 16 percent. These findings were based on research of 43 leveraged buyouts in the United States from 1996 to 2004 with a median transaction value of over 300 million USD. Twenty-three out of 43 were public-to-private transactions. (Kaplan & Strömberg 2009, 131.)

The principles and decision-making concerning remuneration need to be defined clearly. A remuneration scheme can be evaluated by its impact on long-term financial success and the growth of shareholder value. A remuneration scheme can contain, for example, other than financial measures, like customer satisfaction, security of deliveries, satisfaction at work, corporate responsibility, or health and safety at work. (Finland Chamber of Commerce April 2016, 18.)

It’s important that the remuneration scheme is in the right proportion to the company’s life cycle stage. Trust in the remuneration scheme can be enhanced by binding remuneration to key performance indicators and the monitoring of their outcome. Financial and non-financial performance result criteria should be unambiguously measurable for the basis for remuneration. The incentive effect of remuneration on the long-term development of shareholder value can be promoted by vesting periods that cover several years. (Finland Chamber of Commerce April 2016, 18.)

4.4 Internal control and risk management

Internal control and risk management is a process designed to provide assurance regarding the achievement of a portfolio company’s objectives. The risks threatening the achievement of the objectives are effectively managed with appropriate internal controls and a risk management framework. According to the Finnish Chamber of Commerce guidelines for an unlisted company, the purpose of internal control and risk management is to:

> *“…ensure that the company operates efficiently and achieves good results, that information is reliable, and that rules and operative principles are complied with (Finland Chamber of Commerce April 2016, 20).”*

The purpose of risk management is to ensure that risks are identified and monitored by defining risk management principles. Risks may relate to (Finland Chamber of Commerce April 2016, 20):

- decision making,
- the company’s products,
- financing,
- competition,
- personnel,
- environment-related matters,
- contracts, and
- liabilities.

An effective internal control framework requires more than commitment to policies and procedures. It requires judgement from the board of directors and management about how much control is enough. The Committee of Sponsoring Organizations of the Treadway Commission (COSO) framework assists a board of directors and management in identifying and analysing risks. It also helps to develop and manage appropriate responses to risks within acceptable tolerance levels without being overly bureaucratic. For external stakeholders, the COSO framework provides greater assurance in relation to the board's oversight role and, more importantly, the overall confidence in the company achieving its objectives. (COSO May 2013, 1–2.)

The principles of internal controls need to be developed in accordance with the nature and scope of the company's business, geographical coverage, and number of employees (Finland Chamber of Commerce April 2016, 20.) Internal controls are dynamic and integrated processes applicable both for large companies and SMEs. Each company needs to implement an internal controls framework differently based on the context. The internal controls framework in a SME can be less formal and structured but still be effective in use. (COSO May 2013, 2.)

COSO (COSO May 2013, 3) defines an internal control as follows:

> *"Internal control is a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance."*

Figure 6 illustrates the three-dimensional COSO framework based on three objectives (Operations, Reporting and Compliance), five integrated components (Control environment, Risk assessment, Control activities, Information & Communication and Monitoring activities) and the company's organisational structure.

Figure 6. The COSO's integrated framework for internal controls (COSO May 2013, 6)

The three COSO objectives allow a company to focus on different aspects of internal control to clarify what the entity is aiming to achieve. Operations objectives relate to the effectiveness and efficiency of the company's operations and safeguarding assets against losses. Reporting objectives focus on internal and external financial and non-financial reporting which emphasises reliability, timeliness and transparency set by regulators, standard setters and the company's own internal policies. Compliance objectives relate to adherence to laws and regulations which the company is subject to. (COSO May 2013, 3.)

The five integrated components in the COSO framework are helping the organisation to understand what is required to achieve the objectives:

- *Control environment* is the foundation for standards, processes, and structures that provide the basis for carrying out internal controls across the organisation.
- *Risk assessment* involves a dynamic and iterative process for identifying and assessing risks to achieve objectives relative to established risk tolerances.
- *Control activities* are concrete actions guided by policies and procedures that help to ensure that mitigation of risks is carried out across the organisation.
- *Information and communications* mean providing, sharing and obtaining necessary information within the organisation to carry out internal control responsibilities.
- *Monitoring activities* are used to ensure that controls are in use and functioning. (COSO May 2013, 4–6.)

An effective framework of internal controls provides reasonable assurance regarding the achievement of the organisation’s objectives. The five integrated components in the COSO framework need to be present and functioning. Present means that the components and principles exist in the design and implementation of the internal control framework. Functioning refers to the components and principles also continuing to exist and evolve when operations change. (COSO May 2013, 7.) An active ownership and aligned targets create a performance culture which will tend to eventually lead to a better overall governance framework (Dutta, Ganguly & Ge 2015, 26).

5 EMPIRICAL FINDINGS

5.1 Characteristics of the investment process in Sigma

Sigma finances mature profitable SME companies with a focus on supporting entrepreneurs in the development and growth of the portfolio company. Entrepreneurs continue as significant owners with an aim to increase the shareholder value together with Sigma. The following comments well describe Sigma’s investment approach and how they see the relationship with entrepreneurs.

> *“We are an active owner, and we want to partner with an entrepreneur or a group of entrepreneurs. We make decisions together. We are a genuine partner and bring risk sharing." (Partner, Sigma, translated from Finnish)*

Potential target companies land on Sigma’s radar via their own deal flow or from outside contacts who are working in the industry. Both Pi and Rho, for example, came to Sigma via corporate finance advisors who they were working closely with in the private equity industry. When an initial meeting has been held between Sigma and the target company, the process moves on to a workshop phase, where a common business plan is built for the portfolio company. This naturally means that the portfolio company fits the fund’s investment criteria and there is mutual trust between the parties to move to the next phase. From a legal point, there

is a signed letter of intent with a non-disclosure agreement in place before moving to the workshop phase.

The workshop phase includes different streams covering external market analysis, internal analysis, scenario analysis of potential paths forward and financial analysis, which will give financial outcomes outlining the different scenarios built in previous streams. After the financial analysis phase is done, the return profile of the potential investment also starts to take shape. The individual investment is then a consolidated part of the overall fund return estimation, and the potential impact on the fund can be analysed after that.

External market analysis includes a market study where different market drivers, size and growth expectations are identified. Internal analysis covers the portfolio company's own strengths and weaknesses. When a view of outside potential and inside capabilities has been established, potential future scenarios can be formulated. These scenarios include different options for next steps for developing the business. Different options differ in regard to financial outcomes and capital needs. Financial analysis translates preceding streams to a financial outcome and a trajectory for value creation potential, as stated before.

Sigma's partner describes the main difference to a more traditional buyout fund as follows.

> *"What we have, compared to a buyout, we have a greater dependence on the entrepreneur, because we build the case on that. We have an entrepreneur there who is another big owner and who will take the company forward together with us. We are more focused on that, whereas a traditional buyout has a strongly incentivised management that can be replaced if the recruitment is not successful." (Partner, Sigma, translated from Finnish)*

Sigma continues to build and strengthen the relationship with the entrepreneur in the workshop phase. The workshop phase also gives the possibility to evaluate the portfolio company's overall organisational and cultural fit based on identified internal resources and capabilities.

Organisational and cultural analysis has been used to some extent in the latest transactions in Sigma. Human resources due diligence with external consultants is mainly used if there are clear red flags visible during the early phases of the investment process. The reason not to use human resources due diligence in a more systematic way is the fact that external consultants tend to repeat expectations given by Sigma for the assignment, as the following statement describes.

> *"Sometimes it feels as if the conductor of due diligence [HR due diligence] has confirmed our assumptions, which later turned out to be wrong. We are using those more critically and less enthusiastically than at the beginning." (Partner, Sigma, translated from Finnish)*

Sigma also notes that, although the business plan is made together and it is a key process for them, there have also been surprises after the investment has been made in relation to internal capabilities which are not enough to take the portfolio company to another level. Understanding this as early as possible would naturally reduce the risk for the overall investment and give insight to make necessary management changes earlier.

The first thing which usually happens after the transaction is completed is the focus on the work of the board of directors and building the capabilities of the management team. This is especially critical in smaller companies. If the decision making has been concentrated to an entrepreneur or an entrepreneurial team, there is usually potential to build a more efficient and balanced management framework. Sigma's aim is to always have at least two outside independent board members in the board of directors. Some of the portfolio companies are also implementing self-assessment of the board work.

Sigma's operating style is informal in their communication towards the portfolio companies, and they are really close to the management. It's not unusual to have weekly communication with the management of the portfolio companies. Critical steering towards desired targets happens through active on-going informal dialogue between the entrepreneurs and Sigma partners assigned for the specific investment case. There is no written governance policy in relation to corporate governance which is distributed to portfolio companies in the beginning

and executed from day one. Every development action in the corporate governance is planned on an ad hoc basis and customised for the specific needs and context of the portfolio company.

5.2 Case Pi

Pi is a SME with a strong traditional family-ownership background and was fully owned by a single entrepreneur. Both strategic and operative decisions were mainly done on an ad hoc basis without relying too much on data and scenario analysis. Making decisions without deeper data-driven insight was mainly possible due to extensive industry knowledge and pure pragmatism in daily operations to run the business as efficiently as possible from a time perspective. The pragmatic management style was possible in practice due to the fact that the entrepreneur was the key decision maker in all decisions.

There were also other decisionmakers in the company. One was the wife of the entrepreneur who oversaw the function of human resources. The second one was an outsider heading finance and the third one an outsider in charge of the operations (COO) who became CEO of the company after the ownership change with Sigma. The entrepreneur didn't have any children, so the agreement was that the company would be transferred under new ownership at some point. The head of operations had been working in the industry for many years and knew exactly what he would like to change in the company when the ownership changes would materialise. On the other side, you had the entrepreneur's wife who saw the direction of the company in a totally different way. In order to complete the transfer of the ownership from the entrepreneur, succession planning was started in an early phase. The views of the different key stakeholders were far away from each other, as the following comment from the current CEO of Pi describes it.

> *"We started planning it [the ownership change] properly and the goal was that the key people at the time, me, the entrepreneur's wife and our finance person at the time, would be the ones to continue the business. Then when the three of us started going through things and doing something like an owner's strategy, it was probably the first time we sat down and I said, oh no. They want to go there, and I want to go here. I marched in the entrepreneur's office the next day and said that the situation now is that either they*

> *continue, or I continue, together we will not continue." (CEO, Pi, translated from Finnish)*

The entrepreneur didn't yield absolute and ultimate power in every decision, because there was a strong informal layer beneath the formal surface in relation to decision making, as the following comment from the interview with the current COO describes it.

> *"I was left with a very strong impression that the dynamic was a bit special in the sense that he was not such a strong leader and was surrounded by people who strengthened his [the entrepreneur's] leadership. The entrepreneur was a very strong leader and pounded his fist on the table, but then came his wife and she used a different type of power... The entrepreneur said one thing and the wife would say another. Otherwise, the employees had learned that if you ask one of them, if one says no, then it is not the final decision." (COO, Pi, translated from Finnish)*

Another good example describing the informal routines embedded in the organisation was the following description.

> *"I would describe this culture in such a way that you don't have to if you don't want to. There were really strong people here in the personnel… Everything was forgiven, and everyone could do just as much or just as little as they wanted to." (COO, Pi, translated from Finnish)*

Comments from the current COO describing the informal layer within Pi are the most objective, because she wasn't at that point yet employed by the company but was still able to observe organisational dynamics unravelling from close by due to her close connection with the previous COO.

Institution is described, according to Burns & Scapens (2000, 7-8), as shared socially constructed taken-for-granted assumptions for people to express the way things are. Assumptions relate to appropriate activities and relationships between employees who operate within the company (Burns & Scapens 2000, 7-8). The institution which was in place at Pi

before the ownership change had a high level of flexibility within the personnel to change their work description and operative tasks from a very individualistic perspective at the expense of the greater good for the work community and the company as a whole. The possibility to challenge the entrepreneur's decisions was always a backdoor to get one's individual voice heard and needs fulfilled. It's hard to believe that the entrepreneur was not at least to some extent aware of the true course of things within the company, so by accepting the informal decision making and constant flexibility to change things compared to stable formal rules, the company institutionalised flexibility to be the modus operandi.

This as a starting point after the transaction was completed could have caused material difficulties for Sigma to successfully start the transfer and transformation processes of the corporate governance framework if the management had not changed before the transaction was completed. In the old organisational setting, where flexibility was institutionalised, the employees could challenge the corporate governance framework to be implemented in similar ways they have challenged other decisions in the past.

Rules are defined as the formally recognised way of how things should be done, and routines are a manifestation of how things are actually done (Burns & Scapens 2000, 7-8). In the case of Pi, there was a need for a bigger catalyst to introduce a foundation for the rules-based management system and a higher level of standardisation in decision making. The change of the ownership from the entrepreneur to the current CEO and Sigma was the key element to changing the direction of the company. Also, the new COO was introduced to Sigma and started to work at Pi as a COO. The COO's responsibility was focused on internal matters of Pi by building the right organisation, management system and leadership culture to fit the future direction of Pi.

> *"It was already clear to us [CEO and COO] when we were making the business plan [together with Sigma] that the organisation needed to change. When the transaction became public, we immediately knew what needed to be done." (COO, Pi, translated from Finnish)*

"A third of the personnel left immediately because they just didn't adapt to that new operating model." (Partner, Sigma, translated from Finnish)

Organisational change which is consistent with the existing routines and institutions is easier to achieve than change that challenges them (Burns & Scapens 2000, 12). By making bigger changes in multiple areas at Pi, the CEO and the COO were establishing formal rules which would then potentially lead to routines that would align with the business plan built together with Sigma.

We already recognised at the stage of making the business plan that it will be really critical to change the organisational culture. My [current COO] most important task was to turn this tinkering into business." (COO, Pi, translated from Finnish)

"When we went in, we mostly focused on the beginning and modified it well from an entrepreneur-driven, can-I-buy-a-pencil type of thinking, no one had any decision-making power other than the entrepreneur. It becomes a little more self-directed and people dare to make more decisions." (Partner, Sigma, translated from Finnish)

We can categorise the reproduction process at Pi during the ownership handover phase as conscious change, because the CEO and the COO both challenged prevailing institutions and routines. By introducing new rules, they consciously started to reproduce new behaviour within Pi in order to implement new ways to operate that would set the scene for the new business plan implementation. Part of the business plan were the changes in the corporate governance framework of Pi agreed upon together with Sigma. The key change here was establishing a composition and a work charter for the board of directors, which were able to take Pi to the next level in their performance and decision making.

The ownership structure after the transaction was such that 40 percent was owned by the new CEO (previous COO) and the rest was owned by Sigma. The ownership structure has changed after the initial deal, so that the new COO and one key employee are also owners, but Sigma is still holding the majority of the portfolio company.

As stated in the description of Sigma's investment process, one of the main changes that Sigma makes in all investments goes under the governance engineering stream and it relates to setting up a professional board of directors which includes outside independent board members. After the transaction was completed, two outside members were added to the board of Pi, each of which brought their special expertise for the use of the company. Sigma especially wanted to emphasise that different roles should be clear to the new entrepreneurs. For example, it's easy to mix operative, board member and owner roles when tackling daily challenges. This was especially relevant for Pi because the business was affected heavily by the global COVID-19 pandemic.

According to Sigma, it's crucial to have a corporate governance framework in place, especially in the case of Pi. People need to understand the difference between ownership, board member and operative roles. This is linked to the overall risk management and ability to scale up the business for the next level. By bringing independent outside members to the board and understanding different roles in Pi, Sigma started to build a systematic way of governance from the basics. As described earlier, this was lacking completely in the era of the old entrepreneur. As stated in the case description of Pi, both the new CEO and the COO were heavily in favour of the new board composition and the board's work charter, as described in the below statement.

> *"We have already identified at the business plan stage what kind of expertise we would need in the board to support us." (CEO, Pi, translated from Finnish)*

We could even claim that the CEO saw this as a prerequisite for the successful implementation of the business plan agreed upon with Sigma. Here the change was again conscious and not conflicting with the goals of Pi or Sigma, which were aligned in relation to composition and the roles of the board of directors.

According to the Finland Chambers of Commerce governance guidance (April 2016, 14), by defining essential duties and operating principles in a written charter, the board can improve operational efficiency. Sigma holds the chair of the board and implemented a monthly board meeting practice, which handled relevant topics for following up the progress of Pi and initiated discussion related to business development needs or possible acquisition targets to shape market

dynamics more aggressively. This was a clear change compared to the past, as a more formal governance structure started to take shape.

> *"Their idea was to hold board meetings every two months. We told them [Sigma], let's hold those every month. Those [board meetings] are the best sparring moments for us." (CEO, Pi, translated from Finnish)*

In relation to remuneration schemes for the management team, there were no additional needs identified in the business plan. This was due to the fact that the CEO and the COO were already significant owners of the portfolio company, and their interests were aligned well with Sigma. A future development in this area was the possible involvement of the extended management team as co-owners and this way the enhancement of their commitment towards common goals set in the business plan.

In relation to internal controls and risk management, Pi had ISO 9001 and ISO 14001 as quality and environmental management systems. These were the core management systems in place and under constant auditing and development. Pi didn't follow any corporate governance guidelines for SMEs and didn't have any separate written internal controls policy guide in use, due to the fact that the company was focusing more on setting up the governance structure in place for the work of the board of directors and the management team after the rather hectic years of the past ownership.

> *"The governance that is supposed to be developed there is nothing enormously high. It does not go to the level of a listed company in any way, but there was no board work in it, and we brought in those external board members and are trying to bring it to the next level. The CEO and the COO are very hands-on, operative people, and at some point, we will move on from a few challenging situations, so then we should transform their thinking so that they think of themselves as owners, and how they look at this as an owner and think about their own position as an owner. We are dependent on their contribution, and here you can say that, to some extent, we would be in trouble without them." (Partner, Sigma, translated from Finnish)*

This was a clear pragmatic decision from the new entrepreneurs and Sigma, taking into account the size of the company and also the limited resources that were available at the moment in a difficult market situation during the COVID-19 global pandemic. It was important to get the foundation built and develop the governance processes from there.

5.3 Case Rho

Rho is a business spin-off operating in the software industry and can be categorised as a SME company which doesn't have a traditional family-ownership background. Sigma has been an investor in Rho for less than ten years now, already before the spin-off of the software business area. Rho joined forces with Sigma due to funding needs and to accelerate business development and boost commercialisation of their service concept and growth in international markets.

Rho's CEO and other co-owners had been working in the software industry at a big multinational firm for multiple years before founding the predecessor of Rho. This basically meant that the overall understanding of a corporate governance framework and related policies was much clearer for the key employees of Rho compared to Pi, because of their past work experience in the multinational software company. You could also argue that the knowledge of the possible benefits derived from having a robust governance framework in place was very tangible in practice for Rho, as the following comment from the CEO well describes.

> *"Yes, this whole [corporate governance framework] brings that structure and orderliness to everything. Otherwise, this would be a terrible mess and adjustments would be needed for everyone, for the entire organisation, if there wasn't proper corporate governance, who decides and where things are decided and how things are managed." (CEO, Rho, translated from Finnish)*

There had been one professional investor before the Sigma ownership, who introduced a lot of corporate governance related development in the company, which boosted the overall awareness of the topic even further and increased the level of maturity in the corporate governance area before Sigma bought him out. Sigma came to the predecessor of Rho with the

idea to spin-off Rho out of the main business because the funding and development needs varied in different business areas.

Sigma owned 40 percent of Rho in the beginning and the rest was owned by the CEO and other key employees. Key decisions are governed by shareholder agreement linked to the business plan which was made together with Sigma. Sigma's ownership has increased during the years due to equity injections, but the overall road map to develop the company has remained intact for the most part, as it was agreed upon in the beginning when transactions were made.

From the very beginning, Rho has relied on sharing the responsibility among employees with decentralised decision making, which is common in the industry. When your employees are your greatest asset, the company naturally wants to hire and retain the best possible employees by giving them purpose and keeping them motivated to do their best job. There hasn't been any significant internal turmoil in the relationship between the group of entrepreneurs and Sigma after the commonly agreed upon business plan was set in motion. The only thing that caused tension between the parties was when, in the beginning, one software product that Rho was developing couldn't keep up with the deadlines, as the following comment describes.

> *"There have been storms at the beginning, when one software development was delayed. Product development, when it takes a long 1.0–1.5 years, it eats up a lot of money." (CEO, Rho, translated from Finnish)*

The CEO of Rho emphasises many times during the interview the role of the board of directors for the company and the input that Sigma gave in that area after the transactions were made. The expertise of the external board members was especially crucial when scaling the sales capabilities and for the internalisation of the company.

> *"What Sigma brought were these external board members who had expertise and business understanding." (CEO, Rho, translated from Finnish)*

Overall, Rho sees the importance of well-functioning corporate governance from a very pragmatic stance, as the following comment from the CEO well describes.

"Yes, it's [corporate governance] a way of managing the whole company and making decisions about how this company operates at different levels. There is decision-making power and responsibility in the right places. Probably it will bring a certain kind of peace for yourself also when certain things are in order." (CEO, Rho, translated from Finnish)

This has naturally made Sigma's transfer and transformation processes easy, because there is no internal resistance to change, and Rho sees the needed additions to the board of directors in a similar way, to uplift the company's performance in the future.

At Rho, there was a shared socially constructed taken-for-granted assumption to value good governance framework and understand the benefits that could be derived from it. Employees who worked within the company respected the commonly shared rules and worked towards common targets set in the business plan. Routines also appeared to align with the rules set in the corporate governance framework, because different people from the organisation were involved, sometimes even on a weekly basis, with the corporate-governance-related operative or development work. Governance wasn't only a must have exercise to make things look better, it was truly understood as a means to win customer leads and manage the company more efficiently.

Again, we saw the same pattern emerging as in Pi, which is that organisational change which was consistent with the existing routines and institutions was easier to achieve than change that challenges the status quo or something that is against the business plan agreed upon together with Sigma. Rho and Sigma were in full sync regarding the short-term and long-term vision for the company. A crucial pillar to govern the company was again the business plan made during the workshop phase and the composition of the professional board made in the beginning.

The composition of the board of directors changed after Sigma bought Rho. New independent outside board members were added based on their specific expertise. Also, the chairman of the board came from outside, unlike with Pi, where Sigma's partner was the chairman of the board. The CEO of Rho thought that these extra outside board additions brought the necessary skill

set and vision to take sales development and the needed internationalisation capabilities to the next level at Rho. Sigma conducts self-assessment for the board in order to review the quality of the board work and the working methods. The annual clock of the board follows a standard agenda and is prepared by the chairman in close co-operation with the CEO of Rho.

Outside board members have been incentivised with share options, on top of the standard compensation that they are getting from their board duties. Share options are aimed to align the interest with the owners and give an extra compensation tool for Rho. Also, other employees at Rho have the opportunity to get share options as part of their compensation package.

> *"Options are used for remuneration for the board members and members of the management team. All employees have the option to buy a small number of shares also." (CEO, Rho, translated from Finnish)*

Rho doesn't follow any recommended corporate governance framework for SMEs but has implemented the ISAE 3402 standard. This is used by service organisations which are providing transaction processing services of sensitive data for other companies. This is practically mandatory in order to do business in the industry in which they are operating. ISAE 3402 covers the following aspects within Rho.

> *"That control framework [ISAE 3402] applies to the operational side and covers product development, service production and recruitment processes. It also includes financial management and approval limits, approvals of travel invoices, approvals of large payments, approvals of salaries and such, and they have their own controls that the operators take into account… The framework (ISAE 3402) has facilitated our growth." (CEO, Rho, translated from Finnish)*

ISAE 3402 has also had an impact on the growth of the company by giving it a more robust governance framework and a possibility to pursue new potential deals with international multinational companies.

We are less risky, and practices have been improved and new processes have been put into place, which ensures to the customer that no damage will happen." (CEO, Rho, translated from Finnish)

The above statement from the CEO of Rho highlights the maturity level of the company in regard to corporate governance and illustrates the changes which were happening at the tacit level, by constantly finetuning and developing new routines to strengthen the corporate governance framework to support future growth of the company with minor disruption to existing routines and institutions.

6 CONCLUDING REMARKS

6.1 Summary of the study

The private equity industry acts as an accelerator for growth within an economy. Based on an impact study conducted in Finland between the years 2010–2019, the revenue and the number of personnel have grown faster in companies owned by private equity investors compared to the control group (Finnish Venture Capital Association 15.6.2021, 4). This means that a private equity investor has an important role for growing companies but also in creating opportunities for entrepreneurs who need different options for exit. Private equity investors are active and temporary growth-oriented owners in unlisted start-ups and growth companies which, in addition to capital, provide expertise, experience, and extensive networks to support the growth of the portfolio companies (Finnish Venture Capital Association 15.6.2021, 5). This research has been focusing on the buyout investments where a private equity investor makes investments in more established growth companies and usually takes controlling stake of the company.

Corporate governance provides a structure through which the objectives of the company are set and a framework for interaction between a company’s management, board of directors, shareholders and other stakeholders (OECD 2015, 9). The private equity investor usually implements a robust corporate governance framework in the target companies after the transaction is completed. By appointing external board members, a company can establish more independent practices and improve its internal controls, which can result in more accountability

and better risk management. SMEs with a good corporate governance track record can also attract additional funding from investors, as well as prepare the company for a possible IPO. (Mahzan, N. & Yan, C. 2014, 160–161.)

In this research, we have been taking an inside view by investigating the multifaceted relationship and the related corporate governance framework which builds up between the private equity investor and entrepreneurs during and after the acquisition process in a SME context. SMEs do not necessarily benefit from applying the same corporate governance framework as listed companies. A custom-made framework may be more beneficial for SMEs and therefore a corporate governance framework should be flexible and dynamic. (Mahzan, N. & Yan, C. 2014, 165.) Most SMEs do not have separation of ownership and management, as opposed to larger firms (Mahzan, N. & Yan, C. 2014, 160). This is especially visible in the organisational culture, which is heavily impacted by the entrepreneur. Lots of informal routines are embedded within the organisation, which will affect the execution of planned activities, and hence the level of robustness of the corporate governance altogether. By shedding light on the possible challenges of implementing a corporate governance framework and mapping out the possible risks already in the due diligence phase, a private equity investor can increase the probability of succeeding in the investment.

The enforcement of formal principles and procedures could lead to only ceremonial commitment if the informal routines embedded within the company are not analysed and their possible impact and associated risks identified and mapped in the due diligence phase. Managing change requires a thorough understanding of the current context of the organisation. This is especially important in relation to established routines and institutions. The process of change is shaped by a combination of random, systematic and inertial forces, which together create the context out of which new practices emerge. The process of organisational change is therefore path-dependent and not just a rational selection of optimal procedures and techniques. (Burns & Scapens 2000, 13.)

The aim of the research has been to analyse how an organisation's informal routines embedded within the portfolio companies impact the transfer and transformation processes of a corporate governance framework when a private equity investor takes over the company. The transfer

refers to actual plans and concrete action to transfer the preferred corporate governance framework from the private equity investor to the portfolio company. The transformation process refers to the changes in the behaviour in the portfolio company which will either materialise or not based on the planned transfer process. The research purpose has been guided by the following questions, which have directed the empirical analysis. How were the organisation's informal routines related to corporate governance identified and mapped in the due diligence phase? What potential discrepancies emerged between preferred formal principles and actual ones in place at the acquired companies during the transfer and transformation processes?

The case companies included three entities which were Pi, Rho and Sigma. We can categorise Pi as a SME company with a strong traditional family-ownership background. Rho can be categorised as a SME company which doesn't have a traditional family-ownership background. Sigma is a private equity company that finances already mature profitable SME companies. Entrepreneurs usually continue as owners in the portfolio companies alongside Sigma. The financing model of Sigma is used to organise the ownership structure of the company and align the interests of Sigma and the entrepreneurs in the most ideal way for both parties.

The essence of the research has been to examine the transfer and transformation processes of a corporate governance framework in portfolio companies during the due diligence and takeover processes of a private equity investor. The portfolio companies are similar in size with operations categorised as SMEs, but different in respect to ownership background before Sigma's investment. Pi had a strong family-ownership background where the ownership was concentrated to a single entrepreneur before the transaction with Sigma. On the other hand, Rho came from a background where the management had previously worked at a multinational listed company. This gave us a unique research setting to find out if the embedded informal routines and institutions are stronger and stickier in Pi's context compared to Rho, and if this family-ownership background has a material impact on the transfer and transformation processes. Despite the differences mentioned, both portfolio companies were similar in respect to Sigma's ambition to enhance the value of the portfolio companies by establishing a functional corporate governance framework.

This research has been concentrating on understanding why and how organisational practices evolve over time. The key is to understand that organisational change is a process rather than an outcome. Organisational practices can both shape and be shaped by the institutions which exist in the organisation (Burns & Scapens 2000, 5). An institution is defined as shared taken-for-granted assumptions that identify appropriate activities and relationships among a group of people (Burns & Scapens 2000, 8). Rules are defined as the formally recognised way in which things should be done. They are necessary to co-ordinate and give coherence to the actions of groups of individuals. Routines are defined as the way in which things are actually done. (Burns & Scapens 2000, 6.) In the context of the transfer and transformation processes of a governance framework, rules depict the formal rules as governance principles are introduced into the portfolio companies, whereas routines depict the informal activities when the members of the organisation are adapting to a new situation by developing and adjusting their ways of operating within the portfolio company.

A private equity is an asset class which invests in companies which are not quoted on a public stock exchange. What separates different types of private equity investments from each other are the development phase of the portfolio company, and the level and type of financing used. The investment process of a private equity firm has three phases, which are pre-investment phase, investment phase and exit phase. After the investment has been made in the portfolio company, the next step is usually to change the management's incentive structure to provide the management team with incentives to act according to the best interest of the new owners. (Baker, Filbeck & Kiymaz 2015, 5.) Changes in the portfolio company usually start with a review of three restructuring processes which are financial engineering, operational engineering and governance engineering. Governance engineering involves changes in the governance structures of the portfolio company to lower agency costs. This happens by selecting an optimal management team and aligning the interests of private equity investors and managers with the ownership stakes in the portfolio company. It is common that a private equity owner holds board seats to closely oversee the managers to make sure that all desired restructuring measures can be fully implemented by the management. (Rauch & Umber 2015, 75–76.)

This research has focused on analysing the board of directors, remuneration schemes, and internal control and risk management due to the selected approach to investigate the inside view

of corporate governance. Effective risk management helps companies to avoid costly financial distress but can also improve company-wide decision making. The corporate governance framework, and especially the board of directors plays a central role when aligning interests of owners and management and managing risks with an overall target to increase the company's value. The ability of the board to successfully achieve these goals depends largely on its composition and the quality of the working methods. (Gouiaa 2018, 14.)

Organisational change that is consistent with the existing routines and institutions is easier to achieve than change that challenges them. Change that conflicts with existing routines and institutions is more difficult to implement. (Burns & Scapens 2000, 12.) Resistance to change can be classified into three separate but interrelated elements, which are formal and open resistance due to competing interests, resistance due to a lack of knowledge and experience to cope with such change, and resistance due to a mental allegiance to established ways of thinking and doing. Three different characteristics can be utilised to provide ways of classifying and distinguishing between different types of change processes. These dichotomies are formal versus informal change, revolutionary versus evolutionary change, and regressive versus progressive change. (Burns & Scapens 2000, 17–21.)

In the case of Pi, the potential risks related to the transfer process of the corporate governance system relate to a lack of knowledge and experience and to mental allegiance to established ways of thinking. The lack of knowledge and experience is related to new entrepreneurs who don't have the necessary work experience of operating a robust corporate governance system, and therefore the main work in this area lies on the shoulders of Sigma to establish formal rules that support development in this area. Resistance due to mental allegiance to established ways of thinking comes from the history of the company under the previous ownership. Although the new entrepreneurs would be fully on board with the new modus operandi, there are still personnel who have lived in the old entrepreneur's era and can act according to the ways in which things were done in the past in critical moments. It is good to understand this and resolve the potential conflict situations with new ways of working. It takes time to get out of old routines and establish new ones. This is an important factor to bear in mind when developing the corporate governance framework within Pi.

The transformation process of the corporate governance framework after the ownership change was easier to achieve in Pi due to the management's commitment to the newly formulated business plan and the changes that needed to happen within the organisation in relation to corporate governance. The transformation process at Pi can be categorised as formal, revolutionary and progressive. Changes were conscious (formal), fundamental in relation to disruption to old routines and institutions (revolutionary) and enhancing the decision making and the relationship between different stakeholders (progressive).

In the case of Rho, there were no risks associated with the transfer process of the corporate governance framework due to the group of entrepreneurs' earlier experiences working at a multinational company where a corporate governance framework and principles were a part of their daily work. Resistance due to a lack of knowledge and mental allegiance were not visible, which meant that there were no relevant risks to consider from the perspective of Sigma in relation to the transfer process of the corporate governance framework itself.

The transformation process of the corporate governance framework after the ownership change was easy to achieve in Rho due to the management's commitment to the newly formulated business plan and an overall understanding of what benefits can be derived from the corporate governance framework. The transformation process at Rho can be categorised as informal, evolutionary and progressive. Changes were happening on a tacit level (informal) by constantly finetuning and developing new routines to strengthen the framework to support future growth of the company with minor disruption to existing routines and institutions (evolutionary) and enforcing the decision-making and the relationship between different stakeholders (progressive).

The empirical findings are summarised in Table 1 in relation to transfer and transformation processes of a corporate governance framework based on the concepts and vocabulary introduced by Burns & Scapens (2000) witnessed in the case companies during the research.

	Pi	**Rho**
Resistance to change (transfer process)		
1. Formal and open resistance to change	n/a	n/a

2. Resistance due to lack of knowledge	x	n/a
3. Resistance due to mental allegiance	x	n/a
Types of change processes (transformation process)		
1. Formal vs. informal change	Formal	Informal
2. Revolutionary vs. evolutionary change	Revolutionary	Evolutionary
3. Regressive vs. progressive change	Progressive	Progressive

Table 1. The summary of empirical findings in relation to transfer and transformation processes of a corporate governance framework (adapted from Burns & Scapens 2000)

6.2 Conclusions

Based on the empirical findings, the key lever for Sigma, in the area of corporate governance development, was the composition, the roles and the responsibilities of the board directors. This aligns with Gouiaa's (2018, 22) view that the stronger the characteristics of a board, the better the quality of risk management and the lower the level of risk taking in the portfolio company. At the end of the day, risks are the key area that the private equity investor tries to manage via an effective and well-working corporate governance framework.

The special feature in Sigma's approach is the role of the entrepreneur who remains a major owner in the portfolio company after the investment is made. It is also important to highlight that Sigma aligns incentives and goals for future development needs in the workshops together with the entrepreneur at the very beginning of the investment process. This is a key differentiator compared to other funds in the LBO industry, and a consciously selected approach for risk mitigation from their perspective. The value creation potential and opportunities are built together and formalised as a written business plan during these intense workshops.

Due to its ownership structure, Sigma doesn't force new processes and practices to be implemented forcefully from the outside-in, as opposed to a more traditional LBO model, which usually has controlling stake in the portfolio company. A partner of Sigma explains this approach as follows:

> *"We don't offer entrepreneurs an exit, we build an exit." (Partner, Sigma, translated from Finnish)*

> *"Understanding that these investments live and die, what the team [management team] is and how it works." (Partner, Sigma, translated from Finnish)*

We can conclude, based on the empirical evidence, that an organisation's informal routines related to corporate governance and the maturity level of the portfolio company are identified and mapped in the workshops conducted by the private equity investor at the beginning of the investment process. True understanding of the level of corporate governance in the portfolio company is enforced through informal communication throughout the whole due diligence phase. The workshops will also mitigate potential future discrepancies between preferred formal principles and actual routines in place at the acquired companies during the transfer and transformation processes, because a common consensus and the future direction of the portfolio company are formed together in these intense meetings. It can also be stated that material ownership stake of the entrepreneur has an impact on mitigating the potential discrepancies in the case companies. Entrepreneurs are highly incentivised to work together with the private equity investor according to the formal business plan which was formulated together in the beginning.

As the theory suggests, the enforcement of formal principles and procedures would lead to only ceremonial commitment if the informal routines embedded within the company are not analysed and their possible impact and associated risks identified and mapped in the due diligence phase. This case study confirms Burns & Scapens' (2000) views that managing change requires a thorough understanding of the current context of the organisation. This is especially important in relation to established routines and institutions. We can also conclude that organisational change that is consistent with the existing routines and institutions is easier to achieve than change that challenges them. The closer the already existing routines and institutions in the portfolio company are to the to-be state, the faster the transformation process is.

Organisational change that conflicts with existing routines and institutions is more difficult to implement and takes more time and effort both in the transfer and transformation processes. It is important to use (Burns & Scapens, 2000) classification to map the resistance to change. Also, three different characteristics of change processes help to classify and distinguish between different types of changes needed. Change types need to be understood in order to identify the effort needed, and especially to calibrate the approach to cater to the special characteristics of the transfer process in a specific portfolio company.

It can also be stated that a family-ownership versus non-family-ownership background of the portfolio company causes more work for the private equity investor to educate and bring overall awareness about the best corporate governance practices and establishing a foundation for a corporate governance system. The challenges identified in relation to organisation change usually come from the operative level of the organisation, not from the management anymore at this point after the workshops. The source for these challenges at the operative level has been identified to be a lack of knowledge and experience, and mental allegiance to established ways of thinking.

Based on the empirical evidence, we can confirm that the organisational culture is heavily impacted by the entrepreneur. Lots of informal routines are embedded within an organisation which need to be considered when executing planned activities formulated in the written business plan. By understanding the possible challenges of implementing a corporate governance framework and mapping out the possible risks already in the due diligence phase, a private equity investor will increase the probability of succeeding in the takeover and mitigate risk in both the transfer and transformation processes.

Whether the approach chosen by Sigma will lead to a better result and a higher return for the fund is still open, because the investments interviewed haven't yet exited from the fund. Although Sigma's approach can take more time and emphasise the relationship-building with the entrepreneur, the final outcome could yield better results because the entrepreneur remains as a material shareholder through the whole investment and interests are well aligned in the workshop phase.

6.3 Ideas for further research

The focus of analysis in this research has been on the transfer and transformation processes of a corporate governance framework in a SME research setting with and without a traditional family-ownership background. Because our research handles only two case companies, the question of generalisability is valid. This has been compensated by systematic integration of empirical findings with existing literature on institutional theory and change processes.

Generalisation is possible to a certain extent by acknowledging the fact that the research setting is unique, and therefore the validity area of the results can be widened with caution beyond the primary findings. The conclusions describe the overall situation in the portfolio companies when the established historical and present governance practices differ from each other. The argument presented above is mainly derived from a pragmatic stance in the absence of earlier empirical studies. However, the true generalisability of these results will be judged by the readers of the research.

Because there are no directly linked research articles relating to the transfer and transformation processes of a corporate governance framework, the ability to integrate the research findings to earlier research is challenging. This gap in knowledge is a clear indication for further research. The rational approach to fill this gap in knowledge would be a comparative field study comprising multiple portfolio companies with both family and non-family-ownership backgrounds that are in the middle of transfer and transformation processes in funds managed by different private equity investors.

This research could also be regarded as a discussion opener in the research area of corporate governance in a SME context, which mainly deals with best practices. The governance manuals consisting of optimal principles or guidelines fail to capture the behavioural side of organisations and will be lulled into a simplistic view of the organisation's reality. By studying the transfer and transformation processes of corporate governance and the interdependencies between these two processes, it would be possible to take the research tradition in the area of corporate governance in a behavioural direction by lowering the overall risk level and attractiveness of the potential transactions. This type of analysis is clearly needed for a private

equity investor to understand the full potential of the investment and the risks associated with it.

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APPENDICES

Appendix 1: Interviews

Company	*Title / Responsibility area*	*Date*	*Interview length*
PE firm Sigma	Partner in PE firm / Member of the Board Pi and Rho	25.11.2021 16.05.2022	60 min 87 min
PE firm Sigma	Partner in PE firm / Chairman of the Board in Pi and Member of the Board in Rho	30.03.2022	94 min
Portfolio Company Pi	CEO / Member of the Board / Co-owner	22.03.2022	85 min
Portfolio Company Pi	COO / Co-owner	22.03.2022	85 min
Portfolio Company Rho	CEO / Member of the Board / Co-owner	26.4.2022	83 min

Appendix 3: Theme interview questions for the private equity firm

The theme interview structure has been sent beforehand for the interviewee. Sections of *italic text* are supporting notes for the interviewer and those haven't been sent beforehand and aren't visible for the interviewee at any point.

- **Background**
    - Work history
    - Work description and responsibilities in general in the PE firm
    - Work description and responsibilities related to the investment case
    - Legal setup of the fund and roles and responsibilities between general partner and limited partners
    - Fund details
        - Start date, current lifecycle and committed investments out of total AUM
        - Investor profile
        - Fee structure
            - *Annual management fee, share of profit after hurdle rate & monitoring fees*
        - Average holding period of investments
        - Overall target exit strategy for the investments
    - Importance and status of ESG integration in the investment process

- **Investment process**
    - Description of investment process
        - *Pre–investment phase: Identifying suitable target company and plan the future capital structure*
        - *Investment phase: Plan to increase the portfolio company's value and to repay the transaction debt*
        - *Exit phase: Strategy for exit (trade sale to a strategic investor, a trade sale to another financial investor, an IPO, or a combination of different exit channels)*

- Description of screening strategy
  - *Target profile of the potential portfolio company (e.g. industry, maturity, debt capacity.)*
  - *Economic value creation potential*
  - *Valuation based on free cash flow generation capacity and/or relative valuation*

- Description of valuation process
  - *Analytical modelling: Assumptions used for valuation (e.g. firm's growth rate, cost structure, and working capital management efficiency)*
  - *Leverage optimisation: Modelling of capital structure*
  - *Pricing: Valuation method used (i.e. cash flow or multiple based)*

- Description of takeover process
  - *Financial engineering: Efforts to replace the old capital structure and manage earnings*
  - *Operational engineering: Efforts to increase top line and lower the overall cost base*
  - *Governance engineering: Efforts to change the governance structures to lower agency costs (e.g. changes in remuneration scheme, board composition and activity level of PE firm towards portfolio company)*

- Description of due diligence process
  - *Planning phase:*
    - *Technicalities and scope of the transaction*
    - *Availability and skill set of the transaction team and advisors*
    - *Initial view on the target company's financials, competition, management team and organisational culture and sustainability of the business*

        - *Data collection phase: Key business data that are relevant and information sources used*
        - *Data analysis phase: Conclusions drawn based on business–critical factors*
        - *Final report: Content of the final report and the role of governance aspects in it*

    - Description of human due diligence and cultural due diligence processes
        - *Human due diligence: Focus on understanding organisational culture and roles, responsibilities, capabilities, and the attitudes of people in the company*
        - *Cultural due diligence: A holistic view of the cultures of different companies*

- **Corporate governance**
    - Own definition of corporate governance and key components in use

    - Corporate governance applied in the portfolio company
        - *Use of any generally accepted industry guidelines like Finland Chamber of Commerce's guidelines for unlisted companies*
        - *Modification done in the generally accepted guidelines*

    - Personal involvement in the development of corporate governance in the portfolio company

    - Relevance and importance of corporate governance for the portfolio company
        - *Overall awareness level*
        - *Cost vs. benefit analysis*
        - *Impact on initial valuation model and exit enterprise value*
        - *Potential for easier access to debt financing*
        - *Potential to increase in credibility and trust for the portfolio company's management and operations achieving the set targets*

- **Board of directors**
  - Planning of board composition
    - *Impact of context of the portfolio company*
    - *Selection of chairman for the board*
    - *Selection of number of board members*
    - *Role of independent board members and existence of possible conflicts*
    - *Emphasis on special expertise of board members and level of synergy analysis between members*

  - Evaluation of board working methods and results achieved
    - *Internal work distribution of the board and its efficiency*
    - *Contribution of each director in the board work (his or her expertise in relation to the company strategy)*
    - *Satisfaction level of the board of directors and the need for rotation*
    - *Chairman's preparations for the meetings*
    - *Level of information flow within the board (e.g. board materials received beforehand and equal basis)*
    - *Relationship towards the managing director and the management team*
    - *Existence of written charter of essential duties and operating principles*
    - *Existence of annual clock and detailed meeting minutes*

- **Remuneration systems**
  - Planning of remuneration system
    - *Does PE firm require portfolio company to make a material investment in the portfolio company*
    - *Target level of overall ownership of CEO and management team combined*
    - *Impact of lifecycle of the portfolio company for the remuneration system*
    - *Vesting periods used*

  - Description of execution and follow–up processes of remuneration system

- *Principles and decision–making concerning remuneration systems:*
  - *Who is responsible for preparing remuneration plan for approval?*
  - *Financial and non–financial targets used*
  - *Cause–and–effect relationship analysis performed*
- *Method and frequency of follow–up*

- **Internal control and risk management**
  - Role of internal controls and risk management in the portfolio company
    - *Use of any generally accepted internal controls frameworks like COSO internal controls framework*
    - *Modification done in the generally accepted frameworks*
    - *Reasons to have internal control and risk management in place*

  - Key contributors to build, maintain and develop the internal control framework
    - *Commitment to policies and procedures from the board of directors and management ("tone from the top")*
    - *How the nature and scope of company's business, geographical coverage, and number of employees have been taken into consideration?*
    - *Who is responsible for maintaining and developing the internal control framework and risk management?*

  - Description of the internal control and risk management framework objectives
    - *Operations objectives: Effectiveness and efficiency of company's operations and safeguarding assets against losses*
    - *Reporting objectives: Focus on internal and external financial and non–financial reporting*
    - *Compliance objectives: Adherence to laws and regulations which the company is subject to*

  - Description of the internal control and risk management framework activities

- *Control environment: Foundation for standards, processes, and structures that provide the basis for carrying out internal controls across the organisation.*
    - *Does the company have internal controls operating principles manual accepted by the board?*
- *Risk assessment: A dynamic and iterative process for identifying and assessing risks to achieve objectives relative to established risk tolerances.*
    - *Does the company have necessary resources to execute, maintain and develop the framework?*
- *Control activities: Concrete actions guided by policies and procedures that help to ensure that mitigation of risks is carried out across the organisation.*
    - *Does the company have internal controls annual clock with listed activities and reporting to manage these activities?*
- *Information and communications: Providing, sharing and obtaining necessary information within organisation to carry out internal control responsibilities.*
    - *How does the company share information and communicate internal control related objectives and results?*
- *Monitoring activities: Ensure that controls are in use and functioning.*
    - *How does the company track progress, take corrective actions and ensure quality of findings?*

Appendix 4: Theme interview questions for the portfolio company

The theme interview structure has been sent beforehand for the interviewee. Sections of *italic text* are supporting notes for the interviewer and those haven't been sent beforehand and aren't visible for the interviewee at any point.

- **Background**
  - Work history
  - Key highlights of the portfolio company and rationale for joining forces with the private equity firm
  - Work description and responsibilities in the portfolio company
  - Description of past co-operation with the private equity firm related to transaction

- **Investment process**
  - Involvement in the due diligence process
    - *Data collection phase: Key business data that are relevant and information sources used*
    - *Data analysis phase: Conclusions drawn based on business-critical factors*
    - *Final report: Content of the final report with especially governance aspect*

  - Involvement in the human due diligence and cultural due diligence
    - *Human due diligence: Focus on understanding organisational culture and roles, responsibilities, capabilities, and the attitudes of people in the company*
    - *Cultural due diligence: A holistic view of the cultures of different companies*

  - Involvement and role in the change process

        - *Financial engineering: Efforts to replace the old capital structure and manage earnings*
        - *Operational engineering: Efforts to increase top line and lower the overall cost base*
        - *Governance engineering: Efforts to changes in the governance structures of the portfolio company to lower agency costs incl. changes in remuneration scheme, board composition and activity level of PE firm towards portfolio company*

- **Corporate governance**
    - Own definition of corporate governance and key components in use

    - Corporate governance applied in the portfolio company
        - *Use of any generally accepted industry guidelines like Finland Chamber of Commerce's guidelines for unlisted companies*
        - *Modification done in the generally accepted guidelines*

    - Personal involvement in the development of corporate governance in the portfolio company

    - Relevance and importance of corporate governance for the portfolio company
        - *Overall awareness level*
        - *Cost vs. benefit analysis*
        - *Impact on initial valuation model and exit enterprise value*
        - *Potential for easier access to debt financing*
        - *Potential to increase in credibility and trust for the portfolio company's management and operations achieving the set targets*

- **Board of directors**
    - Involvement in planning of board composition
        - *Selection of number of board members*
        - *Role of independent board members and existence of possible conflicts*

        - *Emphasis on special expertise of board members and level of synergy analysis between members*

    - Evaluation of board working methods and results achieved
        - *Internal work distribution of the board and its efficiency*
        - *Contribution of each director in the board work (his or her expertise in relation to the company strategy)*
        - *Satisfaction level of the board of directors and the need for rotation*
        - *Chairman's preparations for the meetings*
        - *Level of information flow within the board (e.g. board materials received beforehand and equal basis)*
        - *Relationship towards the managing director and the management team*
        - *Existence of written charter of essential duties and operating principles*
        - *Existence of annual clock and detailed meeting minutes*

- **Remuneration systems**
    - Role of remuneration system aligning the targets with owners, management and personnel

    - Description of remuneration system (e.g. structure, KPIs and follow–up)
        - *Principles and decision–making concerning remuneration systems:*
            - *Who is responsible for preparing remuneration plan for approval?*
            - *Financial and non–financial targets used*
            - *Cause–and–effect relationship analysis performed*
        - *Method and frequency of follow–up*

- **Internal control and risk management**
    - Role of internal controls and risk management in the portfolio company
        - *Use of any generally accepted internal controls frameworks like COSO internal controls framework*
        - *Modification done in the generally accepted frameworks*

  - *Reasons to have internal control and risk management in place*

- Key contributors to build, maintain and develop the internal control framework
  - *Commitment to policies and procedures from the board of directors and management ("tone from the top")*
  - *How the nature and scope of company's business, geographical coverage, and number of employees have been taken into consideration?*
  - *Who is responsible for maintaining and developing the internal control framework and risk management?*

- Description of the internal control and risk management framework objectives
  - *Operations objectives: Effectiveness and efficiency of company's operations and safeguarding assets against losses*
  - *Reporting objectives: Focus on internal and external financial and non-financial reporting*
  - *Compliance objectives: Adherence to laws and regulations which the company is subject to*

- Description of the internal control and risk management framework activities
  - *Control environment: Foundation for standards, processes, and structures that provide the basis for carrying out internal controls across the organisation.*
    - *Does the company have internal controls operating principles manual accepted by the board?*
  - *Risk assessment: A dynamic and iterative process for identifying and assessing risks to achieve objectives relative to established risk tolerances.*
    - *Does the company have necessary resources to execute, maintain and develop the framework?*
  - *Control activities: Concrete actions guided by policies and procedures that help to ensure that mitigation of risks is carried out across the organisation.*

- *Does the company have internal controls annual clock with listed activities and reporting to manage these activities?*

- *Information and communications: Providing, sharing and obtaining necessary information within organisation to carry out internal control responsibilities.*
  - *How does the company share information and communicate internal control related objectives and results?*
- *Monitoring activities: Ensure that controls are in use and functioning.*
  - *How does the company track progress, take corrective actions and ensure quality of findings?*