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CHAPTER TWO

Entrepreneurship, Organizational Learning, and Capability Building: A Governance Perspective

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Entrepreneurial activities in established companies have two objectives: nurturing and upgrading existing organizational capabilities while building new ones that promote growth (Zahra, 1996). Managing these two seemingly complementary goals can lead to serious conflicts in managing the firm. Efficiency-enhancing routines can enrich the variety of a firm's existing capabilities, allowing it to combine different skills and then apply them in pursuing growth and profitability. These routines can also reduce creeping inertia and allow the firm to safeguard against core rigidities that might develop over time.

In this chapter, we argue that building routines for radically new capabilities or upgrading existing ones is a major challenge for established companies. One source of difficulty lies in the governance systems that determine the distribution of authority, power, and expertise within established companies and influence their willingness and ability to venture beyond their existing skills and competencies. Governance systems also determine the types of entrepreneurial activities that firms undertake and, as result, influence the learning processes associated with developing and acquiring new knowledge.

Our focus on governance systems goes well beyond established companies' formal boards. Rather, we pay special attention to the subtle but pervasive influence of formal and informal power among senior managers and their subordinates on the initiation and pursuit of entrepreneurial activities. Our analysis recognizes the importance of entrepreneurial activities in countering the inertial forces that exist in established companies, thereby setting the stage for the exploration of new ideas that can lead to building new capabilities.

Competence Traps and Organizational Learning

Path dependencies and narrow organizational search in the vicinity of existing knowledge oftens constrain established companies' ability to develop radically innovative ideas for new products, processes, and systems (March, 1991). New ideas or business models have to fight for their survival and acceptance within existing bureaucracies and against managers' preoccupation with ongoing operations. Though building new capabilities is essential for long-term success, it is also a process that is fraught with dangers as existing units may sabotage new initiatives and fight ideas coming from outside their operations. Building new capabilities is a costly, time-consuming process that entails serious risks for senior managers. Experiments in innovation and strategic change sometimes fail and those that succeed may take a longer period of time to reach profitability. These forces increase companies' reliance on well-proven skills and lead to competence traps; situations where a firm's skills fail to keep up to date with the changing competitive landscape (Ahuja and Lampert, 2001).

Some companies excel in developing organizational systems that simultaneously harvest existing capabilities while incubating new ones. These organizations accept the idea that tension between the old and new is a normal part of the process of entrepreneurship and that these tensions should be cultivated. These firms often create separate units and structures that accommodate the unique challenges of different businesses. They also adopt different performance appraisal, compensation, and reward systems (Sathe, 2003). These organizations view the costs associated with different systems as the price to be paid to stimulate entrepreneurship and achieve strategic flexibility. Strategic flexibility rests on the firm's ability to develop and exploit a varied set of capabilities *and* retain the capacity to quickly change the mix of these capabilities (Volberda, 1996). Flexibility enables the company to change its product offerings and respond to market and technological shifts rapidly (Eisenhardt and Martin, 2000; Teece, Pisano, and Shuen, 1997).

The need to achieve strategic flexibility by promoting entrepreneurship to create varied capabilities that could be revised quickly raises major challenges for governance systems (Chesbrough, 2000). In younger start-ups, governance usually reflects property rights. However, in established companies where ownership and control are often separated, governance systems tend to be crafted in a way that harmonizes the objectives of owners and executives. The resulting control systems and compensation schemes have varying and conflicting implications for different types of organizational capabilities. Understanding these differential effects requires attention to the link between governance, decision rules, and organizational learning (Zahra and Flatotchev, 2004) – an issue that we discuss next.

Decision Rules and Organizational Learning

Understanding the importance of governance for capability development requires an appreciation for decision rules. These decision rules are fundamental to how organizations learn, manage knowledge, and interact with their external environments. They take the form of standard operating procedures regarding task parameters, record keeping, and information processing as well as criteria for resource allocation decisions. Cyert and March (1963) view these procedures as the operationalization of the firm's knowledge stock and its method for interacting with the environment. Such decision rules institutionalize satisfying solutions to recurring problems, but are also the source of organizational inertia that constrain organizational learning and condition subsequent patterns of interactions between the firm and its external environment.

Nelson and Winter (1982) suggest that organizational routines encompass both formal and tacit decision rules pertaining to operational and strategic matters. These routines develop over time as the result of firm–environment interactions; they embody the organization's stored knowledge or memory. Further, routines are decision rules that are prone to substantial path dependence and are regarded as persistent, self-sustaining, and heritable. These repetitive routines become strongly imprinted on an organization in the form of reliable and predictable, but also relatively inert, systems and processes. Organizational routines affect not only contemporaneous processes, but they also strongly condition a firm's evolutionary trajectory; the skills it learns and the capabilities it accumulates over time.

Decision rules ensure that organizations and stakeholders do not spin out of control or lose sight of basic organizational objectives. They also reduce uncertainty by codifying standard responses to recurring environmental events. Decision rules also help to overcome problems related to the cognitive biases of decision makers and the retention of tacit knowledge (Foss, 2003). These rules may facilitate complex and coherent organizational responses to complex environmental stimuli. They may also synthesize and communicate collective knowledge that promotes the creation of the social capital necessary to build and sustain a competitive advantage. Paradoxically, these decision rules might inhibit organizational learning (March, 1991) by imposing highly restrictive constraints that can take on an importance about themselves.

In addition, being either more tacit or more formal, decision rules also range along a continuum from simpler to quite complex. Complex rules have the capacity to store more organizational knowledge, but are also more inert. Brown and Eisenhardt (1997) characterize simple decision rules as "semistructures" that provide general guiding principles, but also support a broad range of action and afford decision makers significant autonomy in interpreting and implementing within those parameters. Because complex rules have an inertial effect on organizations, relatively simple rules can be propitious in highly dynamic environments (Eisenhardt and Martin, 2000). Simple rules are integral to the development of dynamic capabilities (Teece, Pisano, and Shuen, 1997).

While simple decision rules support change-oriented organizational capabilities, their development may come at the expense of learning and knowledge retention. Since organizations store much of their stock of knowledge in decision rules (March, 1991), their potential storage capacity is important for knowledge management. The capacity of organizational routines and procedures to store knowledge is a function of their complexity. Since more knowledge can be stored in complex routines than simpler ones, the costs associated with learning and the absence of the capacity to store new knowledge can become a significant barrier to organizational learning. Yet, the absence of complex processes may also adversely influence absorptive capacity, limiting the firm's ability to recognize, value, assimilate, and exploit new sources of information (Zahra and George, 2002).

Complex routines and procedures engender compliance and optimization within existing means-ends relationships. Simple routines and procedures create greater variance and often identify new means-end relationships. Such differences in the effect of complex and simple rules map nicely onto March's (1991) distinction between "the exploration of new possibilities" versus the "exploitation of old certainties." By favoring simple decision rules, companies may sacrifice exploration for exploitation, causing existing capabilities to deteriorate.

To summarize, while a large body of research emanating from Cyert and March (1963) and Nelson and Winter (1982) describes how organizational routines and procedures influence the type and pace of capability development, this literature is silent on the antecedents of these decision rules. We believe that a corporate governance perspective can help to overcome this important gap in the organizational learning and knowledge literatures (Zahra and Flatotchev, 2004). In the remainder of this article, we develop a governance perspective that identifies governance as an antecedent of the type of decision rules organizations use to learn as they pursue entrepreneurial initiatives.

Governance System, Entrepreneurship, and Capability Building

In contrast to agency and transaction-cost conceptualizations of governance, our concept of governance considers not only incentives but also the character of authority relationships and norms of legitimacy that prevail in a firm (Gedajlovic, Lubatkin, and Schulze, 2004). Thus, governance refers to the structured and reinforcing system of authority relations, norms of legitimacy, and incentives that exist in a firm. A governance system imposes fundamental decision rules about the character and purpose of the firm, the basis for and division of prerogatives and responsibilities among key participants, and the means by which relations between these participants are structured. Such decision rules directly impact three fundamental questions: Who should control the organization? For whose benefit? And in what manner?

The literature suggests that decision rules, routines, and procedures in organizations are hierarchical such that higher order routines strongly influence lower order ones (Teece, Pisano, and Shuen, 1997). Thus, an organization's system of governance embodies seminal decision rules that cascade throughout the firm and condition lower level processes and how it learns, manages its stock of knowledge, and interacts with its external environment. To illustrate the links among governance, decision rules, entrepreneurship, and capability building, we examine two archetypal forms of governance, the owner-managed firm and the professional-managed firm.

The owner-managed firm (OMF)

The defining governance characteristic of the OMF is that the rights and responsibilities of ownership and management are coupled in the hands of a single individual. This governance system provides high-powered incentives in the form of large upside/downside risk for the owner-manager and consequently toward efficiency in operations and profit-maximizing behavior. The coupling of ownership and control also grants founders the classic property rights of *usus* (the right to use one's property as one sees fit), *abusus*(the right to alter, modify, or destroy one's property), and *usus fructus* (the right to the profits generated by an asset). The coupling of property rights with managerial control provides owner-managers with the authority to put the firm's resources to their desired use, and the legitimacy and incentive to exercise that authority. The nature of authority and norms of legitimacy in OMFs also mean that they strongly reflect the expertise and personality of their founders, reflecting a multitude of factors such as their upbringing, education, social contacts, cultural heritage, and work experience. Thus, even in large OMFs, organizational goals and performance targets manifest the owner-manager's idiosyncratic goals. Further, the firm's culture is defined by personal norms and is a "tool" operated by and for the benefit of owner-managers.

Owner-managers, who have largely unfettered discretion, define their firms' decision rules. This may occur through a combination of formal and informal processes, resulting in a set of idiosyncratic but relatively simple decision rules regarding the personal goals of owner-managers. Compared to firms with more diffused and complex patterns of authority, these simple decision rules give OMFs significant advantages in pursuing ephemeral business opportunities in dynamic markets. The centralized authority structures and the simple decision rules of OMFs also enable them to excel at opaque transactions and informal contracting, which other types of management may find difficult. The authority and legitimacy afforded owner-managers causes considerable variance in OMFs' strategies and performance outcomes. This often results in less reliable organizations that are prone to failure, but are also more likely to be successful at exploration activities or the discovery of new opportunities and then quickly develop the capabilities necessary to exploit them. These firms are apt to foster a willingness to engage in radical entrepreneurial activities that generate new knowledge. This knowledge serves as the foundation of new organizational capabilities.

Still, the concentration of authority in the hands of owner-managers may work against the development of complex decision rules. Owner-managers tend to be highly possessive of their property and decision rights and may perceive complex and formal systems as a potential threat to their authority. This concentration of power may stifle employees' pursuit of entrepreneurial opportunities and reduce experimentation with new activities that build new capabilities. Further, some OMFs face serious resource constraints that can stifle broad organizational learning. Some OMFs have difficulty in accessing labor and other factor markets or have difficulty hiring and retaining high quality employees and managers. These variables can inhibit the development of the complex systems necessary to partake in exploitative learning, negatively impacting the firm's absorptive capacity and subsequent capacity to build radically new capabilities.

The professionally managed firm (PMF)

A key characteristic of the PMF is the separation of ownership and control. The literature has focused on the incentive features of the governance arrangements in PMFs, concluding that the incentives of professional managers are low-powered because they are paid a straight salary or a mix of salary and market-based incentives. Also, because professional managers don't possess the same rights to profits as owner-managers, their interests are better served by pursuing growth and diversification strategies rather than in maximizing profit. Managers may also advance their own interests at the expense of their shareholders, unless effectively constrained or provided with a strong incentive to do otherwise.

In their role as agents, professional managers hold fiduciary powers "in trust" and need to justify their decisions in terms of their impact upon others (e.g., shareholders) rather than in terms of their own preferences or goals. The legitimacy of their actions is determined by laws and customs and is vetted by the legal system and financial markets. Authority is of the legal-rational variety, diffused within the hierarchy and across highly trained specialists and is vested in the position, not the individual. Decision rules are developed through formal processes (e.g., strategic planning, capital budgeting) and evaluated based on their impact on stakeholders. Thus, the governance of the PMF engenders complex routines, which are developed and operated by highly trained specialists. These routines can promote organizational learning, have positive knowledge management implications, and are also difficult to imitate because of their social complexity and causal ambiguity. Thus, they can form the basis of sustainable competitive advantages. At the same time, the complexity of these routines also makes them relatively inert and impedes organizational responses to the disruptive changes in the environment. Consequently, PMFs are suited for exploitation or optimization activities within known parameters (March, 1991). This is useful in upgrading existing capabilities, but may not foster the development of radically new ones.

The norms of legitimacy and authority structures of PMFs also foster a managerial ethos that values rational discourse and quantification more than intuition and qualitative considerations. Such an ethos makes PMFs less likely to pursue exploration activities or make truly *de novo* entrepreneurial discoveries. Exploration activities are oriented towards producing variance rather than optimizing means-ends; they are more risky and have a lower expected payoff than exploitative activities (McGrath, 2001). Norms of legitimacy in PMFs enable managers to commit resources to more certain exploitative activities than less legitimate exploration. Over time, such decision rules may become strongly imprinted on and routinized in the organization, limiting the sorts of capabilities that can be effectively developed and exploited.

Implications and Conclusion

Our analysis suggests the need for greater attention to the role of governance in shaping the organizational context in which new capabilities are developed and effectively utilized in pursuing entrepreneurial opportunities. Governance systems' pervasive influence goes well beyond providing the incentives for entrepreneurial risk-taking that leads to exploration, learning, and new capability to development. This influence shapes the selection of the various entrepreneurial initiatives and thus the knowledge necessary to build those capabilities. Like March (1991), we see serious trade-offs in exploration and exploitation activities. We have argued that a governance perspective offers rich insights into the behavioral foundations of organizational learning that is integral to successful entrepreneurship. In doing so, a governance perspective suggests the sorts of levers that may be used in managing and selecting a position in relation to the exploration/exploitation trade-off.

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