What is the Impact of Corporate Governance on Organisational Performance?*

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Research on the importance of generally accepted ''best practices'' in corporate governance has generally failed to find convincing connections between these practices and organisational performance. We discuss research outcomes on the relationship between two such ''best practices'' (CEO/Chair duality and insider/outsider composition) and organisational performance, and find this relationship to be insignificant. We propose four possibilities for this tenuous relationship, that are not mutually exclusive: firstly, the possibility that ''best practices'' in governance are indeed irrelevant to organisational performance; secondly, that the operationalisation of theoretical concepts has low face validity; thirdly, that studies are too narrow, aiming to relate board attributes directly to organisational performance and ignoring other systemic factors; and lastly, the possibility that different types of organisations require different practices in corporate governance. Lastly, we address the methodological and substantive implications of each of these possibilities.

Keywords: Corporate governance, best practices, performance, research methodology

The legal formation of limited liability companies in the UK in the eighteenth century has separated ownership from control of corporations (Fama and Jensen, 1983), where salaried managers ideally serve to safeguard and grow the investment of the shareholders, who are the legal owners of the business. The well-documented tendency of managers to often engage in excessive ''on the job consumption'' and wasteful empire building, however, at the expense of the owners' assets and the business itself, has necessitated the institution of monitoring mechanisms, of which the board of directors is an important one.

The effectiveness of boards of directors (or lack thereof) has become a global concern. Corporate collapses, fraud cases, shareholder suits or questionable strategic decisions are attracting attention to the top decision-making body of the corporation; the board of directors. In an attempt to raise the standards of the corporate governance process, ''codes of best practice'' have been drawn up by several countries, global institutions, and institutional investor organisations and adverse publicity is created for companies with what are seen as ineffective governance systems.

The premise for such activism is that good governance means higher returns for shareholders, and vice versa. The problem, however, is that research findings have generally failed to support the purported linkage between such best practices and organisational performance. We suggest four possibilities for this tenuous relationship, and discuss their implications. We then draw attention to the need for an explicit focus on the strategic role of the board of directors, by scholars, practitioners, and regulators, if meaningful relationships between corporate governance and organisational performance are to be established.

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"Best practices" in corporate governance

"Best practices" and organisational performance: the research evidence

"Best practices" suggested by the various codes include separating the roles of CEO and Chairman; having a balanced board both in terms of skills and competencies, as well as in terms of inside/outside representation; having defined criteria for director independence; establishing audit and other committees, such as the remuneration, nomination, and strategy committees; having robust and transparent processes for director appointment; carrying out effective performance evaluations; linking rewards to performance; and communicating adequately and openly with investors. All of these are essentially aimed at improving board independence, transparency and accountability to the company's shareholders and other stakeholders, and its effectiveness in fulfilling both its conformance *and* performance functions (Garratt, 1996).

Does the institution of best practices make a difference to company performance? The weight of the evidence, is that "best practices" that have been researched are not strongly associated with higher firm performance. A study by Calpers found that the 42 companies Calpers targeted for improvement in corporate governance practices outperformed the Standard and Poor's 500 Stock Index by 52.5 per cent in the five-year period following Calpers' involvement (1987 to 1992), whereas these same companies had trailed the index by 66 per cent during the five years before Calpers' involvement (www.calpers-governance.org). Even though these are very significant figures, it is hard to know how much of the stock price improvement can be causally attributed to Calpers' involvement and more effective governance; and the study has not been under rigorous academic peer review before publication, to give assurance of its methodological quality.

Another study by McKinsey Consultants explored whether a monetary value could be placed on good governance (Felton, Hudnut and van Heeckeren, 1996; Hawkins, 1997). The definition of good governance in this study drew from conventional perceptions of best practice. It was defined as having a majority of outsiders on the board; having independent directors with no management ties and who own a significant amount of the stock of the company; who are remunerated to a large extent by stock and who are formally evaluated; and lastly, who are responsive to investor requests. The study found that investors are willing to pay an average of 11 per cent premium for companies they perceive as having good corporate governance. It is important to note, however, that the results of this study do not demonstrate the effects of best practices on firm performance as such. The results demonstrate the effects of investors' *perceptions* of the existence of best practices, on a specific measure of performance, stock price; they are also based on what investors *say* they would do, not what they actually do, which can considerably diverge.

Business Week (2000b) has carried out three surveys of corporate governance so far. These features have been influential in drawing public attention to organisations whose boards either excel or are cited as the worst ones. Three main criteria were used; board independence, board accountability to shareholders, and board quality. Rather unsurprisingly, the report concluded that "good governance, however, is no guarantee of superior performance, as clearly demonstrated by the recent results at Campbell Soup and Compaq. In the past 18 months, the performances of both companies have badly trailed their industry peers and Standard and Poor's 500-stock index". Campbell Soup was third and Compaq was fourth on the most recent list of best boards. Business Week has regularly used individual examples of corporations in its features to illustrate either effective or undesirable practices in governance; but even though these are interesting to note, they are far from representative of the general population of firms (they have low external validity).

More rigorous academic research on Directors' effects on performance has been extensive, focusing on such aspects as board size, outside director representation, director equity, director background and experiences, CEO duality (where the CEO also occupies the board chair role), board involvement in strategy making, board power, and other board attributes (Finkelstein and Hambrick, 1996). This research has produced mixed results, however, not lending clear support to any board attributes as being important determinants of organisational performance. Reasons for mixed results include methodological and conceptual issues such as ignoring other contextual factors and their effects on boards and company performance, insufficient attention to group dynamics, the high complexity of the processes involved which cannot be captured adequately by statistical models, variations in how board attributes are measured across studies, and the use of different measures of performance.

Research on CEO/Chair duality

A key recommendation in codes of best practice is that a separation between the chair and CEO position leads to more independent boards. The Cadbury Code of Best Practice (Cadbury Report, 1992) for example, recommended that ''there should be a clearly accepted division of responsibilities at the head of the company, which will ensure a balance of power and authority, such that no individual has unfettered powers of decision''. The suggestion of separating the CEO/Chairman roles is consistent with agency theory (Eisenhardt, 1989), which assumes that the separation of ownership and control of corporations can lead to self-interested actions of the managers, and conflicts of interest in their role as agents of the owners. Agency theory therefore suggests that CEO duality (the situation where the CEO is also the Chairman of the Board) reduces the monitoring effectiveness of the board over management, and supports separation of the CEO/Chairman roles. Stewardship theory (Davis, Schoorman and Donaldson, 1997), on the other hand, regards managers as inherently trustworthy and unlikely to appropriate organisational resources for their own ends. It thus views CEO duality as fostering strong and unified leadership, rather than as weakening the board's independence from management and its monitoring role.

Empirical evidence, while sometimes supporting this CEO/Chair separation (e.g. Rechner and Dalton, 1991), at other times calls it into serious question. Daily and Dalton (1997), for example, found that CEOs who are also chairs of the board are not necessarily more independent from board influence than CEOs who are not. Baliga, Moyer and Rao (1996), in addition, found no significant relationship between duality status and organisational performance, and suggested that a change in this status from duality to non-duality may be a symbolic move by the board to signal that they are exercising their governance role, rather than a substantive move that can affect performance. Brickley, Coles and Jarrell (1997) also found no systematic link between duality status and organisational performance or market value, suggesting that ''if anything, the evidence suggests that dual leadership is associated with systematically lower cash flows and value – not higher cash flows and value, as reformers claim'' (p. 218).

Research on board insider/outsider composition

Similarly, agency theory supports the idea that boards should be dominated by outside directors, to increase the board's independence from management. The Cadbury code suggests, that ''the board should include non-executive directors of sufficient calibre and number for their views to carry significant weight in the board's decisions''. Stewardship theory, on the other hand, would suggest that control should accrue to firm managers rather than to outsiders, since there is no need to monitor management who are regarded as able and trustworthy.

The common assumption that the existence of social or business ties between CEOs and board members is detrimental to board effectiveness, because it reduces the board's independence from management, was shown to be inaccurate. Such ties can promote more collaborative strategic decision making without necessarily reducing effective board control or vigilance (Westphal, 1999; see also Dalton and Daily, 1999b).

A recent study found no evidence that increasing outsider board representation can improve firm performance; that firms with a supermajority of outside directors perform worse than other firms; and that firms with a higher proportion of inside directors perform as well as firms with a higher proportion of outside directors (Bhagat and Black, 1999).

Wagner, Stimpert and Fubara (1998) reviewed the empirical research related to board composition and concluded that the results are inconsistent. They then carried out a meta-analysis of 29 empirical studies and found that both the greater relative presence of outsiders (non-executive directors) *and* of insiders are empirically associated with higher company performance. This curvilinear relationship was then replicated in a further study; and was shown to hold for asset measures of performance but not for return on equity measures.

Another recent meta-analysis of 37 samples involving 7,644 organisations found that board composition explains less than one per cent of a firm's financial performance; and that a weak influence on performance occurs when there are either relatively more insiders or outsiders on the board (Rhoades, Rechner and Sundaramurthy, 2000), a finding consistent with earlier studies.

Dalton and associates (Dalton *et al.*, 1998) reviewed the significant body of empirical research findings for these two aspects of governance (CEO duality and board insider/outsider composition) and their relation to organisational performance, and found little consistency in the findings. They then carried out a meta-analysis of studies related to these board attributes: For the CEO duality attribute, they identified 31 empirical studies with

69 usable samples involving 12,915 organisations. For the board structure attribute, they identified 54 empirical studies with 159 usable samples involving 40,160 organisations. Their remarkable conclusion, was that:

> ''The results for the board composition/financial performance meta-analyses suggest no relationship of a meaningful level. Subgroup moderating analyses based on firm size, the nature of the performance indicators, and operationalization of board composition provide no evidence of moderating influences for these variables as well. The evidence derived from the meta-analysis and moderating analyses for board leadership structure and financial performance has the same character, i.e., no evidence of a substantive relationship. These results lead to the *very strong conclusion that the true population relationship across the studies included in these meta-analyses is near zero*'' (emphasis added, p. 282).

Why does the research evidence not support suggested ''best practices''?

Thus, the conclusion of several rigorous studies on the performance effects of CEO duality and of insider/outsider board representation, is that these factors do not really make much of a difference.[1] Clearly, these results cannot be ignored by any serious student, practitioner, activist or regulator of governance. The fact is, however, that they are consistently being ignored by those organisations that purport to know what the ''best practices'' in corporate governance are, and especially by vocal institutional investors. These findings may go beyond suggesting that we need different practices to suit different contexts. One potential interpretation is that the practices themselves may be irrelevant to organisational performance.

There are a number of possibilities (not mutually exclusive) as to why the research does not support suggested best practices in governance. Each of these possibilities has different implications for action.

Possibility #1: The attributes researched, and related ''best practices'', are indeed irrelevant to organisational performance

Accepting this possibility would, after all, only mean an acceptance of the conclusions of recent meta-analyses of empirical studies, that found no meaningful relationships between some of the most strongly advocated ''best practices'' and organisational performance. The ''best practices'' that have been shown to have no (or very weak) relationship to performance, as discussed above, relate to the suggestion of separating the CEO/Chair positions, and having a majority of outsiders on the board. If further ''best practices'' are researched extensively (for example the effects of directors owning equity), and their relationship to organisational performance is similarly found to be insignificant, then this possibility will be strengthened.

Johnson, Daily and Ellstrand (1996) raised possibility #1 in conclusion to their extensive review of the governance literature:

> ''To our knowledge, there has been no documented evidence of the existence of a unicorn. With tongue slightly in cheek, there can be two general rationales for our failure to 'discover' this legendary species. First, this animal simply does not exist. Second, we have not searched in the right place, at the right time, with the right equipment. In many ways an aggregation and summary of the boards of directors/financial performance/other outcomes literature has this same character. Maybe such relationships simply do not exist in nature. Or, if they do exist, their magnitude is such that they are not of practical importance'' (Johnson, Daily and Ellstrand, 1996: 433).

Related to this possibility, is the idea that while ''best practices'' in corporate governance may be irrelevant to performance, ''bad'' practices (such as a co-opted board that has a low degree of significant external linkages and a low level of relevant and appropriately balanced expertise) may be more strongly related to underperformance; in other words, good governance may be a qualifier rather than a differentiator; a proposition that merits further investigation.

This possibility has the most radical implications for the current state of affairs. If it is correct, then a fundamental rethinking of the significance of corporate governance is in order, by all stakeholders concerned. Scholars must start searching elsewhere for the influencing factors on performance; governments, global organisations and institutional investors must rethink the direction of their regulatory demands on corporations; meanwhile, practitioners will keep hoping that robust and consequential prescriptions can arise from all the research and ''best practice'' guidelines.

Possibility #2: The operationalisation of theoretical concepts and principles has low face validity

One example would be the operationalisation of the concept of ''board vigilance'', with the implication that higher board vigilance would lead to a higher level of organisational performance. Proxies for board vigilance that have been used, include proportion of outside board members, and extent of directors' ownership of firm equity. The problem lies in trying to measure an essentially behavioural attribute, however, with indicators that may only have a circumstantial connection to this attribute. Other factors such as personality and a sense of duty may be more important to whether a director is vigilant rather than structural factors such as whether they are insiders or outsiders or whether they own equity. Vigilance is manifested in actual behaviours, however, and accessing and recording board behaviours (rather than asking about structural factors in surveys) is thus essential to judging the level of board vigilance.

Daily, Johnson and Dalton (1999), in addition, found that there is a plethora of operationalisations of ''board composition'' in empirical research, that are not mutually consistent and in fact do not constitute a robust operationalisation of the concept of ''board independence''. Independence is not merely a structural attribute; it is a psychological trait that gives rise to corresponding behaviours. Board composition may therefore be related to, but is not an adequate proxy for board independence.

What might be useful in this case is qualitative research based on direct observation and in-depth interviewing, on which subsequent quantitative studies can build, to increase both the validity of operationalisation and reliability of measurement through triangulation (Jick, 1979). Several scholars have called for such field studies (Finkelstein and Hambrick, 1996; Gillies and Morra; 1997; Heracleous, 1999). The fact that such studies are so scarce (for exceptions see Pettigrew and McNulty, 1995; Roberts and Stiles, 1999) may have more to do with the boards' unwillingness to be studied in this way, than researchers' willingness to undertake them.

The implications of this possibility call for scholars to pay more attention to improving the face validity of their operationalisations; and draw attention to the potential usefulness of behavioural observations and in-depth interviewing of directors and boards in the field, in order to identify behaviours that matter and that point to, for example, higher board vigilance or other concepts being measured.

Possibility #3: The influences on organisational performance are too complex to find significant relationships in narrow studies of board attributes

Figure 1 below (from Heracleous, 2001) is a simplified representation of factors influencing organisational performance. Its theoretical underpinnings derive from the strategic choice perspective (Child, 1972), Mintzberg's (1978) distinctions between intended, realised, unrealised and emergent strategies, and the

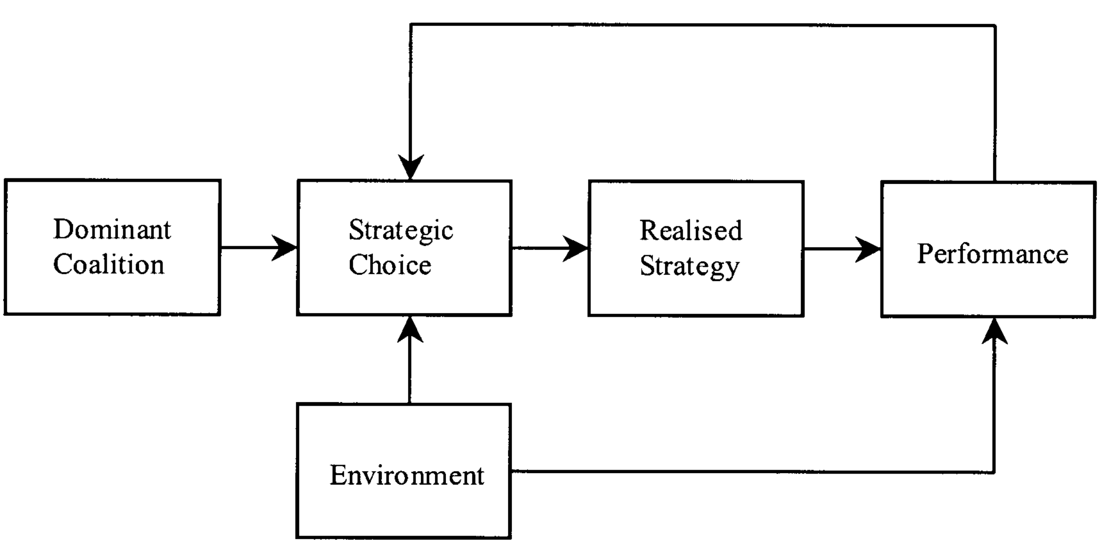

Figure 1: Factors influencing organisational performance

strategic management field's concern with firm performance (Rumelt, Scheldel and Teece, 1994).

Given that organisational performance is influenced by the organisation's strategy (strategic choice and most importantly implementation), and to a lesser extent by various interrelated factors in its micro and macro-environments, then it is apparent that board attributes *per se* may be of little consequence; *except in so far as they influence strategic choice and implementation*. Attempts to correlate board attributes with performance, without an adequate consideration of systemic influences, or of a linkage with their strategic significance, is thus bound to produce weak and inconsistent results.

Possibility #3 implies that scholars need to develop methodologies that can account for multiple, systemic and multi-directional influences on organisational performance, and to avoid models that attempt to correlate directly board attributes and performance. From this perspective, the implicit assumptions underlying such models (that the factors influencing firm performance are linear and uni-directional) can be seen as too simplistic.

Possibilities #2 and #3 essentially imply that the problem of not finding a significant linkage between corporate governance and performance, is a methodological as opposed to a substantive one. According to possibility #2, the operationalisation of variables has low face validity and consequently reliability; according to possibility #3, an overly narrow methodological approach is used, that cannot do justice to the complexities of the real-world phenomenon. But if the problem is confined to possibilities #2 and #3, the underlying principle that good corporate governance (as generally perceived) leads to better organisational performance is not questioned. Gillies and Morra (1997: 77), for example, support this point of view when they argue, ''common sense tells us that there is a relationship between corporate governance and firm performance. The fact that various empirical macrostudies in corporate governance have been unable to identify it does not mean that this relationship does not exist''.

The fact that the institutional investor community is virtually ignoring research findings that question the relevance of ''best practices'', may be related to these two possibilities. In other words, if institutional investors believe that studies are too narrow and of questionable validity, then from their own point of view, they have good reason to ignore them and go on demanding corporate governance reform as if there is no evidence questioning such ''best practices''.

Possibility #4: Different types of organisations require different board practices

This is a concern expressed by several practitioners, who see the possibility of excessive regulation in corporate governance as restrictive and of limited practical use; especially if it follows the ''cookie-cutter'' approach. In this view, research results are inconsistent because a particular board attribute or structure might be appropriate for one type of organisation, but inappropriate or even detrimental in another.

While companies such as Intel or General Motors have paid much attention to aligning their corporate governance processes to suggested best practices, publishing extensive details on their web sites, and wishing to be seen as leaders in corporate governance practice, others, especially dot.com companies, ignore most of the suggested best practices; especially when it comes to board independence from management (*Business Week*, 2000a). Some argue that conventional best practices do not apply to virtual firms' fast-moving environments that demand flexibility and fast decision-making, and that stock options granted to executives in these organisations align their interests sufficiently with the company's interests; so that there is no real need for monitoring by the board. Critics reply that this is no substitute for good governance based on a diversity of viewpoints and expertise, and on the presence of a strong independent element on the board.

Whatever the merits of this particular debate, the wider idea that organisations should tailor their structures and processes to their task and environment has had a long and well-researched history in management studies, in the form of contingency theory (see Donaldson, 1995 for a useful collection of key works). Important studies in corporate governance have productively utilised a contingency framework (e.g. Finkelstein and D'Aveni, 1994; Pearce and Zahra, 1991, Zajac and Westphal, 1996) Pearce and Zahra's (1991) study, for example, validated the existence of different board types, and found that ''participative'' boards (characterised by higher CEO power and high board power) are associated with the highest level of company financial performance.

This possibility implies that scholars need to explicitly incorporate a contingency perspective in their studies. This would draw attention to addressing not simply the board's monitoring role (as advocated by agency theory); but its expertise and counsel roles (consistent with stewardship theory) and its linkages with external resources (consistent with the resource dependence perspective) (Dalton *et al.*, 1999), as well as a more explicit focus on the organisational task and context. It would also mean that relevant contingency variables are proposed, based on theory and empirical findings, and explicitly considered in subsequent theory building and research design.

For example, a prospector organisation (Miles and Snow, 1986) with a flexible and decentralised structure operating in fast-moving environments, may require different board structures and emphasise different director roles than a defender organisation with a functional and centralised structure, operating in more stable environments. In the prospector organisation, relevant director counsel and expertise (consistent with stewardship theory) that is treated as an important input in strategy formation, may be a more important determinant of strategic success than a high degree of CEO and managerial monitoring by the board (consistent with agency theory).

A contingency approach may also help to place several conflicting prescriptions of agency and stewardship theories in context. Since conflicting prescriptions for practice exist, it follows that one of these two theories must be less applicable in a given empirical context. The challenge therefore lies in identifying the types of contexts in which different theories are most applicable. Possibility #4 goes beyond suggesting that we need better operationalisations; it suggests that we need better theory. Such theory-building would concentrate on identifying relevant contingency factors and how they influence the empirical applicability of different theories.

Addressing multiple board roles and their relative significance in task environments characterised by different contingency factors would potentially lead to a more pragmatic contextual understanding of corporate governance processes, as well as to potentially useful prescriptions for executives and for other stakeholders.

Conclusion: the need for a strategic perspective in corporate governance

We discussed recent research on the importance of selected ''best practices'' in corporate governance, that has generally failed to find convincing connections between these practices and organisational performance. We then proposed four possibilities for this tenuous relationship, that are not mutually exclusive: firstly, the possibility that ''best practices'' are indeed irrelevant to performance; secondly, that the operationalisation of theoretical concepts has low face validity; thirdly, that studies are too narrow, aiming to relate board attributes directly to organisational performance and ignoring other systemic factors; and lastly, the possibility that different types of organisations require different practices in corporate governance. We also addressed the implications of each of these possibilities; the first implies that corporate governance ''best practices'' need to be radically rethought and that a healthy dose of skepticism is in order regarding such practices; the second implies the need for higher face validity of operationalisation through behavioural observation and in-depth interviewing of directors; the third implies the need for research models and paradigms that can account for systemic and multi-directional influences; and the fourth one implies that a contingency perspective needs to be incorporated in studies of governance.

In discussing possibility #3, the point was made that corporate governance can be highly influential to organisational performance in so far as it is related to the strategic management of the corporation. This is a proposition theoretically grounded in the findings of several studies that a company's strategy is highly influential on organisational performance (e.g. Rumelt, 1991; McGahan and Porter, 1997). Even in very tough industries characterised by intense competition and slim profit margins, there are organisations that consistently deliver superior returns to their shareholders, chiefly as a result of effective strategy development and execution. Examples of these abound; Dell in the PC industry, Microsoft in the software industry, and Singapore Airlines in the airline industry. Careful study of these companies reveals that they have developed distinctive competencies to support innovative competitive strategies that set them apart from their competitors. Boards, sitting at the apex of organisations, are ideally the bodies that should help to develop and ensure the successful implementation of sound competitive strategies.

Boards have the strategic task of monitoring top management, being involved in such issues as executive succession, executive compensation and take-over defences. In addition to managerial monitoring, however, boards should more importantly be actively involved in strategy formation, especially on issues such as diversification, resource management and strategic change (Finkelstein and Hambrick, 1996). Empirical data (Dulewicz, MacMillan and Herbert, 1995) indicates that directors take their strategic responsibilities seriously; they believe that their tasks should involve the formation of vision, mission and values, direction of the company's strategy and structure, delegating to management and maintaining appropriate relationships with shareholders and other interested parties.

Descriptive studies of what actually happens, however, have often shown that boards' actual performance may not live up to this normative view (O'Neal and Thomas, 1996). Finkelstein and Hambrick's (1996) extensive review states that ''the virtually uniform conclusion that comes out of this research stream is that boards of directors are not involved in strategy formation'' (p. 228). Boards are thus usually at best involved in strategy ratification rather than formation, and avoid ''rocking the boat'', especially when confronted with a powerful CEO. Director and board evaluation is rarely if ever carried out, and there are usually no systematic processes for identifying and selecting suitable candidates to serve as directors, but instead reliance on the personal networks of the chairman, CEO or other directors (O'Neal and Thomas, 1996).

Given the importance of strategic management for organisational performance, it is thus necessary for studies of governance, as well as boards of directors in carrying out their role, to have a clear strategic focus. This would draw attention to the fact that a director's role is not simply to be a monitoring mechanism over management (as advocated by agency theory); but also to offer expertise and advice (consistent with stewardship theory) and to offer linkages with external resources (consistent with the resource dependence perspective) (Dalton *et al.*, 1999).

Thus, useful future methodological directions for research on corporate governance would include (i) a higher concern with the validity and reliability of measurements (ii) employment of methodological triangulation, through the use of fieldwork primary data as a rich resource for improving the operationalisation of concepts (iii) the explicit incorporation of a contingency perspective in both theory building and theory testing (iv) a strategic focus on how boards influence (or don't) various aspects of the corporation's strategic management process (v) a focus on factors related to productive group dynamics as part of a higher concern with board process than simply with board structure. These factors would hopefully lead scholars to a deeper understanding of the ''territory'', through more accurate mapping techniques and maps; and improve the dialogue between the various stakeholders, through the production of robust descriptions and consequently sound prescriptions.

Note

1. For critical discussions that seriously question another suggested ''best practice'', paying directors in equity, see Dalton and Daily (1999a); and Daily, Certo and Dalton (1999).

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