The Relationship Between Governance and Performance: Literature Review Reveals new Insights

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Abstract: The topic of governance has been the attraction of much research for the last four decades. Governance has proven to be difficult to study, and attempts to explain how boards actually contribute to business performance have failed to produce definitive results. Much of the research to date has employed the statistical analysis of large quantitative data sets based on conventional hypothetico-deductive approaches to knowledge development. Numerous variables have been isolated that have appeared to be significant in a normative input-output sense, even though assumptions of congruence within the black box of governance cannot be relied upon. Qualitative data and interpretive approaches have also been used. Some of this later research has produced fascinating results, yet the difficulties of developing theory from case research remain. The aim of this paper is to summarise the governance literature, and to introduce critical realism as an alternative approach within which to explore governance, especially research into the relationship between governance and performance. A review of the governance, methodology and decision-making literature has revealed new insights. First, several mechanisms that appear to be significant to the governance–performance relationship are apparent in the literature when the governance phenomenon is considered holistically. These include active engagement; an involvement in the development of strategy; the making of strategic decisions; and, the adequate monitoring of strategy implementation. Second, critical realism, a philosophy of social science, appears to be a viable alternative philosophy within which to explore governance, and the supposed relationship between governance and performance in particular. Finally, the longitudinal multiple-case study methodology – informed by empirical data collected from boardroom observations, semi-structured interviews and the inspection of archival governance records – has the potential to provide the deep understanding necessary to make causal inferences about the governance–performance relationship. Together, these insights provide an interesting basis for future governance research efforts; particularly research that moves beyond the limitations of positivist and interpretivist approaches and the extant theories of governance, towards an explanation of the elusive governance–performance relationship and, potentially, a refined conceptualisation of governance.

Keywords: governance, strategy, decision-making, critical realism, causal mechanism, case study

1. Introduction

Researchers have studied the topic of governance for several decades (Tricker, 2012). Many aspects and attributes have been investigated including structure; composition; and, to a lesser extent behaviour. Much of the research has utilised large data sets using quantitative analysis and conventional hypothetico-deductive science. However, governance, a complex, dynamic phenomenon (Sargot & Rita, 2011), has proven to be difficult to study (Adams, Hermalin, & Weisbach, 2010). Despite considerable effort, attempts to produce a comprehensive theory of governance, or explain how boards of directors (henceforth, boards) actually contribute to business performance, have failed to produce definitive results to date (Lee, 2011; Machold, Huse, Minichilli, & Nordqvist, 2011; Pugliese et al., 2009).

Boards are responsible for the optimisation of company performance in accordance with owners' wishes (Bainbridge, 2002). Therefore, governance is perhaps best understood through the decisions made by boards as they seek to achieve this outcome (whatever that may be). A review of the literature suggests that the value that boards contribute to company performance is mostly dependent on their activity (what they do), rather than on the attributes of either their structure or composition (what they are). An active and ongoing involvement in the strategic management process appears to be significant. More specifically, the consideration of strategic options; an involvement in the development of strategy; the making of strategic decisions; and, the adequate monitoring of strategy implementation and subsequent performance (Bonn & Pettigrew, 2009; Crow & Lockhart, 2013; Lee, 2011; Useem, 2012; Wheelen & Hunger, 2006) all seem to be significant. Further, company performance appears to be enhanced when the division of labour between board and management (Lockhart, 2012) is clearly defined and understood; efficiently implemented; and, both groups are actively engaged in the governance process. The restatement of governance and management in the form of a division of labour has the potential to move the research locus away from the inspection of governance attributes, towards the activities of governance and the underlying mechanisms that cause outcomes. The identification of causal mechanisms is an important step towards explaining the relationship between governance and performance, and to assist in determining the impact that boards have on company performance. However, given the impasse reached with positivist and interpretivist approaches, an alternative research philosophy and methodology appears to be required in order to gain a deeper understanding of the underlying and potentially unobservable mechanisms; to make causal inferences; and, to credibly infer a re-conceptualisation of governance. This recommendation denotes a significant shift away from the low-hanging antecedent variables explored by many researchers to date.

This paper is organised as follows. First, a summary of the governance literature is provided and several potentially causal mechanisms are identified. Critical realism is then introduced as an alternative research philosophy, and the longitudinal multiple-case study as a useful methodology. How this approach and this technique are expected to contribute to the understanding of the governance–performance relationship is then discussed. Finally, conclusions and opportunities for future research are presented.

2. Governance research to date

Much of the governance research undertaken to date has employed the statistical analysis of large quantitative data sets and conventional hypothetico-deductive approaches (Ketokivi & Mantere, 2010). Numerous variables that have appeared to be significant in a normative input-output sense have been isolated (Boone, Casares Field, Karpoff, & Raheja, 2007). These include board size (Coles, Daniel, & Naveen, 2008); CEO duality (Dalton & Kesner, 1987); gender diversity (Simpson, Carter, & D'Souza, 2010); non-executive directors (Cadbury, 1992); behaviour (Larcker & Tayan, 2011); and, power (Peebles, 2010). Qualitative data and case-based interpretive approaches have also been used (Lockhart & Taitoko, 2005). While some of this research has produced fascinating results, the nature and characteristics of the supposed relationship remain undetermined (Bozec & Bozec, 2012), as no credible explanation has been provided (Lee, 2011).

The stark polarisation of governance research – along positivist and hermeneutical lines – has resulted in the production of statistical correlations between observable variables on one hand, and rich descriptions on the other. However, the constant conjunction of variables described in the literature does not constitute a causal explanation of the governance–performance relationship that has been postulated by leading researchers (e.g., Huse, 2007; Huse, Hoskisson, Zattoni, & Vigano, 2011; Nicholson & Kiel, 2007; Yermack, 1996). Notwithstanding this limitation, several theories have been proposed – including agency (Jensen & Meckling, 1976), stewardship (Donaldson, 1990) and resource dependency (Pfeffer & Salancik, 1978) – although none account for all cases of governance (Nicholson & Kiel, 2007). An inherent epistemological gap, whereby empirical knowledge cannot credibly predict future performance, limits the validity and reliability of the theories of governance that have emerged (Donaldson, 2012) Although Bhaskar (1975) and Sayer (1992) both argued that regularities are neither a necessary nor sufficient condition of causality. This assertion suggests that it is not realistic to attempt to establish causality in any Humean sense using hypothetico-deductive science. Therefore, an alternative approach is required.

Governance is perhaps best understood through the decisions made by the board, because these ought to extend to company performance outcomes. Considerable strategic decision-making research has been reported in the management and psychological literature (Steptoe-Warren, Howat, & Hume, 2011), although the literature is relatively devoid of research into the board's role in strategic decision-making (Lockhart, 2010). Notwithstanding this, strategic decision-making – and specifically the board's involvement in the development of strategy and the making of strategic decisions – appears to be an important factor when considering the governance–performance relationship (Bonn & Pettigrew, 2009; Crow & Lockhart, 2013). If a relationship between governance and performance exists, as has been postulated in the literature, a change in performance is likely to occur at some point after a board decision: provided the decision has been actioned effectively by management. However, the strategic management literature indicates that business performance is affected by many endogenous and exogenous factors (Wynn & Williams, 2012), some of which cannot readily be observed. This suggests that a research philosophy capable of exposing board's strategic decisions; the underlying mechanisms behind these decisions; and, company performance changes, which is not reliant on regularities or the exclusive use of publicly available empirical data, appears to be pivotal to the success of future governance research.

The paucity of any conclusive hypothesis to explain the relationship that supposedly exists between governance and performance indicates that our understanding about how boards contribute to strategy and performance is, at best, limited (Leblanc & Gillies, 2005; Vandewaerde, Voordeckers, Lambrechts, & Bammens, 2011). That we cannot confirm, let alone explain, the impact of governance on company performance – or how boards actually influence performance – is a significant gap, in both the literature and in practice. Notwithstanding this, efforts to understand the contribution that boards make must continue, especially given that governance is of "enormous practical importance" (Shleifer & Vishny, 1997, p. 737); the board's mandate to maximise company performance (Bainbridge, 2002); and, the important economic (Gamber & Scott, 2007; Healy, 2003) and societal benefits (Ahlstrom, 2010; Friedman, 2005; Schefold, 1979) that flow from high company performance. Therefore, more research is required, especially inductive theory-building research supported by normative justification grounded in empirical data and a deep understanding of underlying causal mechanisms, if a robust explanation of the supposed relationship is to be provided and a re-conceptualisation of governance developed.

3. Critical realism

The complex, socially dynamic nature of governance (Edlin, 2007) suggests that a qualitative research design and inductive reasoning is the appropriate approach through which to gain new knowledge about governance. Indeed, Hume (1911) asserted that the establishment of causality was only possible via inductive theory-building approaches, providing that they are subsequently tested. However, the research fortresses and philosophies that have failed to provide insight to date must first be dismantled (Daily, Dalton, & Cannella, 2003), and the research agenda changed (Aguilera, Filatotchev, Gospel, & Jackson, 2008; Huse, et al., 2011) if the epistemic fault line that exists between the extant theories of governance is to be bridged, and a definitive understanding, explanation and re-conceptualisation (Smallman, 2007) achieved.

An alternative research philosophy and approach that moves beyond the empirical study of isolated governance attributes and regularities, to the holistic investigation and conceptualisation of the phenomenon itself (Finegold, Benson, & Hecht, 2007; Quine, 1991; Wirtz, 2011) is required to pursue the discovery of the causal mechanisms that explain the supposed relationship adequately. Critical realism (Bhaskar, 1975), a philosophy of social science, and the case study method (Yin, 2002), appear to provide this much needed alternative.

Critical realism rejects the positivist assumption of universal closed systems, empirical regularities, and the positivist view that social phenomena (of which governance is an example) are a mass of separable events or attributes (Bhaskar, 1998). As such, it affords the potential to overcome the "theory-induced blindness" (Kahneman, 2011, p. 277) that has arisen as a result of the dominance of agency theory and positivist approaches in governance research. Epistemologically, critical realists emphasise pluralism and opportunism (Kurki, 2007). They also argue that all social research is influenced by assumptions, postulates and a subjectivist epistemology; that a real world exists, but there is no way of proving or disproving this; and, that a clear demarcation between quantitative and qualitative research methods is somewhat artificial (Cruickshank, 2003).

Critical realism provides a means of advancing governance research beyond the impasse that has been arrived at with the use of traditional epistemological approaches (Friedrichs & Kratochwil, 2009) that have been favoured by many governance researchers. It assumes that reality is intransitive, utilising a stratified ontology which distinguishes between the real, the actual and the empirical (Bhaskar, 1975), and provides a generative view of causality (Outhwaite, 1987). The real, actual and empirical layers described by Bhaskar are emergent. For example, the properties of governance are considered to be different from those of the CEO; the Chair; and, various structural attributes of boards. However, the roles and identities are internally related. The board cannot be explained at the level of individual directors or attributes, only in terms of the governance relationship with the company. Critical realism places a special emphasis on the development of theory, and on the use of theory to provide sound explanations of social phenomena. This guides researchers towards more holistic and methodologically pluralistic causal theories (Kurki, 2009) – theories that are not dependent on empirical data alone, or on regularities between events or attributes. As such, critical realism enables governance researchers to abandon positivism and empirical realism, without having to embrace postmodernist ontology (Age, 2011).

Research that seeks to understand and explain how boards, and specifically decision-making therein, work requires an intensive comparative research strategy, such as, the case study. There are several reasons why the much maligned case study method is appropriate. First, the literature suggests that critical realism provides a powerful philosophical validation (through ontological and epistemological support) for the use of case studies, particularly to develop theory (Easton, 2010). Second, governance is a complex, socially dynamic phenomenon (Byrne & Ragin, 2009; Edlin, 2007; Huse, 2007; Leblanc & Gillies, 2005; Vandewaerde, et al., 2011). The case study is widely recognised as the appropriate method when conducting in-depth research into a complex socially dynamic phenomenon with many relationships and variables (Bryman & Bell, 2007; Darke, Shanks, & Broadbent, 1998; Eisenhardt, 1989; Ragin & Amoroso, 2011; Yin, 1984, 2009). Third, the case study also has the potential to expose causality in situations that are too complex for survey or experimental methods (Hillebrand, Kok, & Biemans, 2001; Johnston, Leach, & Liu, 1999). Fourth, case studies are well suited to addressing "how" and "why" questions (Chetty, 1996; Eisenhardt & Graebner, 2007; Yin, 2009). Yin (2009) argued that the more the research question seeks "to explain some present circumstance, the more that the case study method will be relevant" (p. 4). Finally, the case study method enables researchers to learn more because they get close to the phenomenon within a real-life context, and report rigorously. The case study is the preferred method when the phenomena being studied is not readily distinguishable from its context (Yin, 2002). In contrast, scientifically-based methods (including surveys and experiments) typically extract the phenomena from its natural context (George & Bennett, 2005), and many variables are controlled.

The making of causal inferences (King, Keohane, & Verba, 1994) about complex, socially dynamic phenomena requires a holistic approach (Byrne & Ragin, 2009). Further, such causality is emergent. It is typically dependent on, and may only operate under, certain contingent conditions (George & Bennett, 2005). The literature indicates that methodologies founded upon critical realism enable complex organisational phenomena to be investigated in a holistic manner (Wynn & Williams, 2012). Miles and Huberman (1989) demonstrated that it is possible to postulate causal influence in social science research without resorting to statistical measures. Using data gathered from multiple settings, causal influence can be established. The *longitudinal* (twelve month) *case study* appears to provide such an opportunity. Therefore, an iterative case-based design (Rashid, 2011) – founded on critical realism (Bhaskar, 1975; Kurki, 2009; Sayer, 1992) and several different methods of data capture (Onwuegbuzie, Johnson, & Collins, 2009; Zachariadis, Scott, & Barrett, 2013) – is more likely to reveal new, epistemologically robust, insights. Ultimately though, the discovery of any new and credible conceptualisation of governance is most likely to emerge from an inductive inference, because all new knowledge is interferential (Potter & Colapietro, 1996).

It should be possible to obtain knowledge of the properties of the supposed relationship, and identify the causal mechanisms, using an iterative deductive–inductive design (Christensen & Raynor, 2003; Dubois & Gadde, 2002; Holton, Chang, & Edward, 1996; Shepherd & Sutcliffe, 2011) which draws on both quantitative and qualitative traditions (King, et al., 1994), and the direct observation of governance decision-making *in situ* (Leblanc & Gillies, 2005), because assumptions of congruence in the black box cannot be relied upon (Lawrence, 1997). The longitudinal (twelve month) multiple-case study method will enable decisions made by the board to be identified; the response of management to be monitored; subsequent changes in business performance to be observed and associated with prior decisions; and, comparisons between different decisions and contexts to be made. Abductive reasoning is of considerable importance in this context, because it provides a credible link between induction and deduction (Mingers, 2012). Abduction, unlike pure induction, commences with a reason to believe that a proposition is true. Therefore, abductive reasoning has value in understanding governance–performance causality, because a relationship between governance and performance has been postulated.

4. Conclusion

The making of strategic decisions, and their impact on performance, is an important consideration for governance research. A review of the literature suggests that critical realism, the longitudinal case study method and abductive reasoning together provide a means of advancing governance research beyond the impasse (Friedrichs & Kratochwil, 2009) reached by governance researchers who have utilised exclusively positivist or interpretivist approaches. Therefore, it may be productive for future research efforts to utilise these insights to establish whether a relationship between governance and performance exists in certain company conditions, and attempt to identify causal mechanisms. If strategic decision-making is identified as being significant, a new conceptual model of governance that infers strategic decision-making as a causal mechanism in certain company conditions may well follow.

Notwithstanding the success of future research efforts to infer a new conceptual model of governance that explains the relationship between governance and performance, company performance ultimately remains somewhat dependent on management to implement the strategic decisions made by the board; the board's effective monitoring of management; and, other endogenous and exogenous factors. Further, theory development from causal inferences is not perfect (Jeffreys, 1961). All boards are open systems (to a greater or lesser extent), with a variety of patterns of human agency that influence decision-making and performance. Consequently, the conceptual contributions emerging from such efforts will, necessarily, remain tentative. Nevertheless, they should be significant.

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