Is corporate governance a structure, a process, a group of policies, or something else?

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Abstract

Over recent decades boards of directors and corporate governance have become the subjects of much research. Many definitions and concepts of corporate governance have appeared in the literature—more so as knowledge about companies; shareholdings; boards; management; board–management interactions; and, control has expanded. However, no singular concept of corporate governance appears to have been universally accepted. This deficiency is most likely because the ontological basis of the phenomenon/field is yet to be resolved.

The empiricist concept in the literature, frequently cited in practice holds that corporate governance is a structure, a process, policy framework or some combination of all three. However, boards, board–management interaction and corporate governance seem to be “the product of a plurality of structures” (Bhaskar, 1989, p. 3) that can be associated hierarchically. Thus, the continued pursuit of a single immutable truth about boards; a one-size-fits-all theory of board–management interaction; an optimal board structure; or, a universal market-based or policy-based corporate governance system may be futile. Though the practitioner community has at various times embraced *all* such arguments, the socially dynamic nature of boards and the open system within which they operate must be accounted for if credible explanatory theories are to emerge.

This conceptual paper comments on the various concepts/constructs of corporate governance that have been proposed in the literature. Informed by boardroom observations, it seeks to advance the preliminary work of Crow, Lockhart and Lewis (2014), by providing an alternative conceptualisation that seems better suited to corporate governance and how boards actually work.

Keywords: corporate governance, critical realism, mechanism

Introduction

Companies are understood to play an important part in modern economies. They contribute to and are influenced by the economies and societies within which they exist and operate. Important economic (Bozec, Dia, & Bozec, 2010) and societal benefits (Friedman, 2005; Schefold, 1979) flow from high company performance to the economy and communities within which the company resides. Consequently, knowledge of how high company performance can be achieved may have value to the overall functioning of economies and societies, and as a consequence, to the growth of strong and vibrant communities. The role of the board, which provides an important link between company shareholders and managers (Berle & Means, 1932) has been discussed in the literature. Boards are typically introduced by shareholders to represent their interests following the separation of 'ownership' and 'control' (Fama & Jensen, 1983) that occurs as a result of shareholders no longer working within the company in which they hold shares. The board has a mandate to optimise company performance (Bainbridge, 2002) in accordance with the wishes of shareholders. Therefore, the responsibility for business performance lies with the board of directors, and it is the shareholders to whom the board must provide such an account of performance

An emergent problem

The phenomenon of corporate governance is closely associated with boards. Many different definitions of the term have appeared in the literature (Aguilera & Jackson, 2010), although references to the term 'governance' in a business or corporate context were rare before 1960. The first explicit usage of the term 'corporate governance' appears to have been by Eells (1960). He made reference to "the structure and functioning of the corporate polity" (p. 108)—the polity presumably being the board of directors and/or senior managers who may have had director roles. The term 'corporate governance' does not then appear to have been used again in the peer-reviewed literature for almost two decades. It was subsequently used by Williamson (1979) in his study of the transaction-cost economics (TCE) to describe "a framework within which the integrity of a transaction is decided" (p. 235). This definition seemed to extend Eells' earlier concept by suggesting that corporate governance could be a structure (Adams, Hermalin, & Weisbach, 2010), a process (Pitelis, 2004), or a policy framework (Carver, 2010); through which shareholders' interests are represented, protected, or pursued in some way.

The Oxford English Dictionary (2010) states that the English word 'governance' is derived from the Greek word *kubernetes* (to steer or pilot), via a Latin derivation *gubernare* (to direct or rule) and the Old French word *gouvernance*. This suggests that governance is an activity associated with movement; with setting direction or guiding something towards a longer-term or major goal, or at least with some purpose in mind. Another modern English word 'cybernetics' provides further insight. Cybernetics—also derived from the Greek word *kubernetes*—emerged from control theory to describe feedback loops and control systems (Wiener, 1961). In being applied to management, Beer (1967) suggested that cybernetics is "the science of communication and control" (p. 7), a definition that implies a short-term or efficiency mindset (based on feedback and closed systems). Together, these two derivations suggest that corporate governance could be conceived as an activity with longer-term direction and shorter-term feedback cycle elements, all in the corporate context of separation between owners and their boards. The longer-term direction setting merges overall business objectives, strategy development and approval. The shorter-term feedback cycle relates to the navigation, decision-making and adjustments required to guide the business towards the agreed objectives supposedly via business and corporate strategies.

Notwithstanding these early references and definitions, the *concept* of corporate governance was discussed—but the term was not used—in the business literature much earlier (Berle & Means, 1932), with the separation of ownership and control in companies and the need for a structure to define or control interactions. That neither of the terms ‘governance’ or ‘corporate governance’ were used in any of the articles (Berle & Means, 1932; Fama, 1980; Jensen & Meckling, 1976) frequently cited in the board and corporate governance literature is somewhat ironic—much needed adumbrations (Merton, 1968)? The separation of ownership and control is discussed at length in Berle and Means, and in Fama and Jensen (1983). However, reference to the terms ‘governance’ and ‘corporate governance’, as some sort of structure, process, system, or policy framework through which problems associated with the separation can be addressed, is tacit in these articles, at best. Hence the difficulties researchers have faced since, namely, that the ontological basis of the phenomenon appears to be unresolved, and a universally accepted definition is yet to emerge.

Most of the definitions and descriptions of ‘corporate governance’ that were provided in the literature up until the late 1990s emphasised the monitoring and control aspects of the exchange between boards and managers. The definition provided by Shleifer and Vishny (1997), which has been widely cited, was representative of those suggested during the period:

> Corporate governance is a means by which various stakeholders exert control over a corporation by exercising certain rights as established in the existing legal and regulatory frameworks as well as corporate bylaws. (p. 374)

Shleifer and Vishny appear to suggest that corporate governance might be some sort of a system, which is activated for a purpose (to exert control) by various stakeholders, within a legal and regulatory framework. However, no reference is made to the purpose of the corporation; constructs of business goals or objectives are not mentioned; while business performance is ignored. Nor is the board explicitly mentioned! Shleifer and Vishny may have considered the board to have the same status as other stakeholders, or that stakeholders are the entities that exert control. While this possibility is speculative, it is generally consistent with Berle and Means’ (1932) and Fama and Jensen’s (1983) earlier theses, which describe the need for a structure and a mechanism when the control of company operations is separated from the ownership of company shares—excepting the status of the board and shareholders, which are typically elevated above other stakeholders. Consistent with the highly influential agency theory (Jensen & Meckling, 1976), researchers and practitioners appear to have interpreted this guidance to mean that a clear separation between the board and management is necessary, and that monitoring systems and various controls are the means through which shareholders' interests are represented, protected and pursued.

Broader definitions of the term 'corporate governance' began to appear in the literature around and after the turn of this Century (Wirtz, 2011). Scholars began to explore the possibility that the board's involvement in value creation (Huse, 2007) might be advantageous to the achievement of the wishes of the shareholders. However, the primary emphases that had dominated earlier descriptions—monitoring and control—were not ceded (Davis, 2005). The dominant conceptualisation of the board and of corporate governance remained one of structure and process. The assumption that good corporate governance leads directly to good company performance and, by implication, to the proper functioning of an economy appears to be foundational (see OECD definition, 2004),. While this association seems plausible—possibly self-evident to some practitioners—unambiguous definitions of 'good corporate governance' are yet to emerge at this point in the academic literature. As importantly, if not more so, should be the concern that robust evidence linking good corporate governance with good company performance and the proper functioning of the economy still remains elusive.

Research approach and analysis

A theoretical redescription of corporate governance appears to be necessary if a credible explanation of how boards can influence business performance is to be achieved. Crow (forthcoming) recently conducted a critical realist-inspired longitudinal case study of two high-growth companies in an attempt to advance common understandings beyond the conceptualisations that have dominated the research and practice landscapes. Several techniques including observation, interview, document inspection and informal discussion were used to collect data from primary and secondary sources for analysis and theory development. Respondent validation (Bloor, 1978) and triangulation (Huettman, 1993; Stake, 1995) were both used to ensure the validity and credibility of the data (Vallaster & Koll, 2002), especially the verbal statements and notes written during observations and interviews. The Lockhart and Taitoko (2005) synthetic timeline framework was used to collate and provide a holistic overview of the data. Associations between various board tasks and subsequent changes in business performance became apparent during the analysis, particularly after the data streams were collated and placed in the LT framework.

A reasonably consistent relationship between board activity and business performance was evident in the data collected for this research. However, positive outcomes (upwards inflections in business performance) were not assured just because directors performed certain strategic management practices. Board engagement appeared to be necessary to the exertion of influence. However, engagement *per se* did not appear to be an antecedent variable to business performance outcomes. On occasions revenue growth was observed to occur despite any explicit engagement or involvement of the board, even though engagement did appear to be an important contributing factor when the two boards sought to influence business performance. The observed association appears to support the descriptions and relationships that have been provided in the literature (Wheelen & Hunger, 2006): That when directors are actively engaged, together, in the fulfilment of their statutory duties and responsibilities to the company and to shareholders, then influence over business performance is *possible*.

The joint and universal commitment of the case study directors to a common understanding of the core purpose of the company, a strategy and performance objective also appears to be important. The analysis revealed that the boards often made decisions more quickly—and with a greater level confidence—during periods characterised by high levels of teamwork and alignment between directors. This observation is consistent with Lorsch's (1995) findings. While the directors did not always agree with each other, and decisions initially received less than unanimous support from time to time, empathy and trust between the directors appeared to be material to prompt decision-making and functionality, and through which unanimity was achieved. That the empirically observable actions of the board (e.g., development of strategy or making of strategic decisions) did not necessarily nor consistently result in desired business performance outcomes suggests that any influence that the board may have is more likely to be as a result of other—unobservable—powers or social mechanisms, but only when they are active or activated. Other endogenous and exogenous influences in addition to any task performed or strategic decision made by the board may exert influence over performance. Consequently, a singular board structure or composition is unlikely to be causal to business performance (Dalton, Daily, Certo, & Roengpitya, 2003; Demsetz & Lehn, 1985) or value creation (Kraus & Britzelmaier, 2011) in any deterministic sense.

The analysis of the two longitudinal datasets laid out on the LT framework using analytical resolution (Danermark, Ekstrom, Jakobsen, & Karlsson, 2002, see p. 109) revealed common patterns of activity and relationships. When the purpose of the company was clearly defined and communicated; the board was committed to its achievement; and, the board was engaged in the development of strategy together with management strategic decisions were made in an appropriate context of core purpose and agreed strategy. If the board continued to be engaged after a strategic decision was made, by closely monitoring the implementation of its decisions; ensuring the company complied with necessary statutory requirements; and, holding management accountable for strategy implementation and business performance, then the likelihood of the board's decisions being implemented as expected, and of the expected impact of decisions being achieved was greater than if monitoring did not occur, performance was not verified, or if either were ineffective.

This preliminary conclusion, that the board should be actively engaged in several strategic management practices (including but exceeding the monitoring and controlling management tasks that form the basis of much board activity (Agrawal & Knoeber, 1996)), as conceptualised by agency theory (Jensen & Meckling, 1976), does not necessarily mean that execution of these tasks results in outcomes in a repeatable manner, or is necessarily causal to business performance at all. The correlation between board tasks and subsequent business performance was not consistently evident in the data collected for this research. This seems to be consistent with the theoretical understanding of complex, socially dynamic structures: That any influence that the board, as a decision-making body, may have on business performance is unlikely to be due explicitly and exclusively to any observable task that the board performs; or, the structure or composition of the board; or, any set of policies and regulations; or, any specific behaviour of directors. However, companies do not and cannot operate in isolation. The environmental context within which the company operates (the market), the requirements of shareholders and other endogenous and exogenous factors also appear to exert some influence on decision-making, business operations and, ultimately, business performance.

An iterative process of abduction and retroduction (Clark & Blundel, 2007) was used to expose underlying attributes or mechanisms that appear to be necessarily activated when boards seek to exert influence on business performance through the completion of certain strategic management tasks. Several attributes were consistently evident when the directors were actively engaged in the strategic management practices identified above, and the board was operating in a functional (Leblanc & Gillies, 2005) manner. Individual directors appeared to be skilful and capable; they were actively involved in the completion of certain board tasks; they maintained a focus on the purpose of the company, strategy and future business performance; they worked collaboratively; and, they displayed a commitment to make decisions together and to make adjustments and exert control adjustments as needed. These five attributes—skill, involvement, collaboration, future focus and adjustments—are suggested to be the empirical expression (that is, proxies) of several underlying qualities of directors and social interactions between directors. Some of the identified attributes appear to be qualities possessed by individual directors seeking to make effective contributions. Others are more likely to be social mechanisms that can only be activated when directors work together in a corporate governance context—that is, when the board meeting is in session. The underlying qualities and mechanisms that appear to coincide with the empirical expressions are suggested to be the constructs of strategic competence; active engagement; a sense of purpose; collective empathy; and, constructive control. Effective contributions in the boardroom seem to be dependent on the harmonious activation of these five constructs together, as demonstrated by the results. However, if any one or more of these qualities or social mechanisms are not apparent—because the qualities are either not possessed or expressed by the directors, or the board does not activate the mechanisms—the level of influence that the board is able to exert on business performance was compromised. Not unexpectedly though, high performance may still occur, but not from any influence exerted by the board!

Developing this conceptualisation further, corporate governance is suggested to be a company-level mechanism that can be activated by engaged boards as they seek to exert influence over the achievement of business performance outcomes. More specifically, the corporate governance mechanism appears to be activated by directors who possess certain qualities and express them in a social context (the board meeting). Expressed in this context, social mechanisms are activated, the purpose of which is to complete specified strategic management tasks effectively, in the pursuit of business performance outcomes. The analysis also suggests that the interaction between the qualities and mechanisms is not straightforward. The actions and behaviours of individual directors can be, and often were, somewhat idiosyncratic. Actions and behaviours interacted in different ways, depending on the specific circumstances and preferences of directors at that time, prevailing group dynamics, the requirements of shareholders and market conditions, as well as other endogenous and exogenous factors.

Discussion

The important strategic management tasks (higher level constructs) necessarily performed by boards appear to be the development of strategy (together with management); the making of strategic decisions (in the context of approved strategy); and, the monitoring of strategy implementation, that is the verification of business performance and the control of management in the context of both approved strategy and statutory requirements. Underlying social mechanisms appear to be the crucial interactions that occur between directors when they work together in order to perform these tasks effectively and thus activate the organisational level mechanism. If directors do not possess the suggested qualities or they do not express them and, by omission, the social mechanisms are not activated, then the important strategic management tasks identified here are unlikely to be completed effectively. Consequently, the company-level mechanism will not be activated and the board's influence over business performance will be minimal.

This proposal suggests that corporate governance is neither a structure, a process nor a set of policies. Rather, it may be more effectively conceptualised as a company-level mechanism—to be activated by boards and from which to better pursue business performance outcomes. The primary components of the corporate governance mechanism are suggested to be strategic management tasks, lower-order social mechanisms and underlying qualities possessed by directors (as shown in Figure 1 below). The hierarchical expression of these components suggests that corporate governance is, in effect, a multi-faceted and multi-functional mechanism that can be activated by boards to develop strategy; make strategic decisions; monitor strategy implementation; and, verify business performance, all in the context of both the stated long-term purpose of the company and the wider operating context.

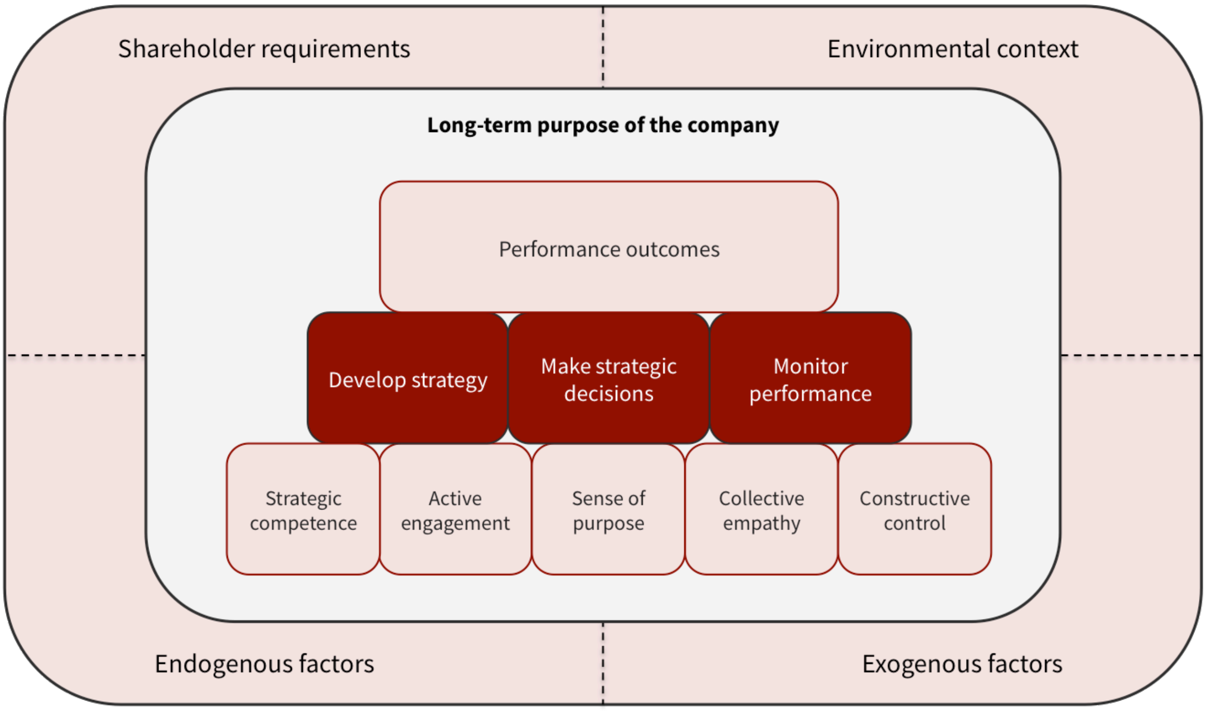

Figure 1: Corporate governance: A stratified company-level mechanism

This reconceptualisation of corporate governance, as a stratified company-level mechanism, appears to provide a seemingly adequate explanation of the observed board–business performance relationship, and of how boards influence the achievement of business performance outcomes under specific conditions. It offers an alternative view to empiricist conceptualisations of corporate governance (a structure, or process or policy framework) that have been espoused in the literature and are frequently citied in practice. It is grounded in the strategic management literature, organisational theory, an Aristotelian conception of phronesis, a critical realist-inspired approach to research and a deep understanding of primary data collected from within boardrooms and of the organisational context within which the boards and the companies operated during the longitudinal study. The board's active involvement in the strategic management process appears to be crucial if the board is to exert any meaningful influence. More specifically, when directors possess strategic competence and collective empathy and express those qualities as they work together, and they activate the identified social mechanisms (active engagement, sense of purpose and constructive control) and perform strategic management tasks together in the boardroom, changes in business performance can follow.

While a theoretical explanation has been provided in this paper, the explanation itself should not be interpreted to be a grand theory applicable to all boards and board situations. Neither should it be interpreted to be a predictive theory. Rather, the mechanism-based conceptualisation of corporate governance presented here seeks to provide guidance towards a contextual understanding of the underlying qualities of directors and social mechanisms that, when activated by directors in board meetings, appear to be necessary if boards are to exert an influence on business performance.

Paradoxically that a company can exist and continue to operate without the mechanism of corporate governance in place and functioning well is apparent in practice. However, whether the company can operate effectively over the long term is a question that merits further enquiry. This question provides a foundation upon which to conduct further research. The answer should assist others determine whether the mechanism-centred conceptualisation of corporate governance, as described above is appropriate, and whether or not it is required in all cases. At this stage in the synthesis such outcomes are expected in the short-term anyway.

The actual business performance achieved by companies ultimately remains dependent on managers to implement the decisions made by the board; the board's effective monitoring of managers and management activity; and, numerous other internal and external factors. The board and the mechanism of corporate governance proposed in this thesis form a complex, open system. Further, theory development from qualitative data and causal inferences is not perfect (Jeffreys, 1961). A variety of patterns of human agency can and do influence both decisions made in boardrooms and subsequent business performance outcomes. Many directors cannot predict their own performance, let alone that of the board they sit on or the company. Consequently, the conceptual contribution emerging from this research is, and should remain, tentative.

Conclusion

This research sought to understand if and how boards influence the performance of the companies they direct and govern. A counter-factual approach to the study of boards, the board–management interaction and business performance was embraced. The research brought commonly separated elements and tasks together; marking a return to the conceptualisation of boards and shareholder–board–management interactions as Berle and Means (1932) may have conceived in their original thesis. That others—including Jensen and Meckling (1976) and Fama (1980)—subsequently moved the locus of research away from the absentee shareholder (the basis for the board in the first place) is no fault of Berle and Means.

The proposal that emerged from this research challenges the conception that corporate governance is a structure (that is, the board) or a process (that is, a sequences of activities), or policy framework (of rules and regulations), or some combination of the three. Rather, the contention of the proposal is that corporate governance is a company-level mechanism that is activated by competent, engaged boards in the pursuit of business performance outcomes, via strategic management. Perhaps it might go some way to redressing the major digression that occurred between 1932 and 1976, when Jensen and Meckling first published their now oft-cited paper. While it is crucial to proceed with further knowledge creation with caution, it may now not be too bold to suggest that a significant breakthrough remains possible. A paradigmatic revolution, as described by Kuhn (1970), appears to be one step closer.

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