An Exploration of the Board Management Nexus: From Agency to Performance

James Lockhart and Peter Crow
Massey University, Palmerston North, New Zealand
j.c.lockhart@massey.ac.nz
peter@petercrow.com

Abstract: For its first half century, examination of business performance by the strategic management discipline largely focused on activities conducted or led by the CEO. Since the mid-1990s that examination has widened to include the board of directors. Unfortunately, empirical research exploring the board – business performance relationship has produced limited new knowledge. From this deterministic attempt the discipline appears little the wiser in establishing the root cause of business success. Throughout the period normative propositions have proliferated (e.g., Peters & Waterman, 1982; Hamel & Prahalad, 1994). Latterly these propositions have expanded to include the role and responsibility of the board and its contribution to performance (Huse, 2007; Leblanc & Gillies, 2005; Nicholson & Kiel, 2007; Lockhart, 2012). Despite the normative limitations embedded in some of these works the practitioner community of shareholders, regulators, and stakeholders are increasingly holding boards responsible for unsatisfactory performance. It is notable that the lack of reliable and repeatable empirical evidence to support this relationship has not deterred increasing expectations on both communities' behalf. That causality is rarely mentioned, let alone researched, should concern both parties. Exploration of the board management interface has been dominated by agency approaches (Daily, Dalton & Rajagopalan, 2003). The dominant logic of that research is the continued need for managerial opportunism to be constrained by the board. Quite how such activity would contribute to business performance appears to have escaped the attention of many contributors. However, if the board management interface is motivated by the common pursuit of business performance, agency problems could be of little consequence. Under such circumstances other theories in the middle range (Merton, 1956) appear to provide more credible explanations of the causative nature of the board's contribution to business performance. The aim of this paper is to briefly explore the board management nexus from the division of labour (Lockhart, 2012); emerging perspectives of power (Peebles, 2010); and, ownership (Andersen, 2012). Efforts with black box research (Forbes & Milliken, 1999) have produced correlations between variables and robust descriptions but rarely explanations or quantifiable empirical output. The inevitable case study approach required for black box research, however rich, continues to abet theory building (cf., Eisenhardt, 1989). Results of the sustained pursuit of black box research, now into its second decade, suggest that the common pursuit of performance can be described first, as a function of the division of labour between board and management. Second, power exercised by a subset of the board and management appears to provide an explanation of what gets discussed and, therefore, what gets implemented. Third, the role of owners in setting and maintaining the purpose of the firm, while often neglected in practice, has recently been re-recognised as important. Of more concern than the lack of any unifying theory in governance is the continued pursuit of research from the agency perspective, implicit now in much of the plethora of best practice recommendations for governance. Shifting the lens from agency to a common desire for business performance, as demonstrated here, is identified as being rewarding for the common good of researchers and practitioners alike.

Keywords: board management nexus, black box

1. Introduction

Much of the governance research conducted to date has employed quantitative designs involving large data sets using conventional 20th Century hypothetico-deductive science. Despite this effort governance researchers have largely failed to identify conclusive outcomes (Huse, Hoskisson, Zattoni & Vigano, 2011). However, some contributors suggest that a relationship between governance and subsequent company performance does exist (Huse, 2007; Nicholson & Kiel, 2007) and that its identification is simply a matter of changing the lens through which research is conducted (Leblanc & Gillies, 2005; Lockhart, 2006). Various hybrid designs (Aichelburg, Sexl, & Bergmann, 1979; Rashid, DeZoysa, Lodh, & Rudkin, 2010) utilising *both* deductive testing of the proposition that a relationship exists, and inductive theory building grounded in empirical data (Binder & Edwards, 2010; Glaser & Strauss, 1967) are expected to reveal new insights. Such research activity may eventually confirm the existence and nature of the elusive governance-performance relationship thereby giving support to shareholders and regulators on-going shift in their assignation of responsibility.

2. The division of labour

The traditional passive practice of governance is largely related to the need for compliance. The need for compliance can be attributed to limited liability bestowed upon a company's owners: the shareholders

(Micklethwaite & Woolridge, 2003). The compliance regime is also a response to the supposed agency problem (Jensen & Meckling, 1976) created by the separation of wealth (Berle & Means, 1932) and the subsequent need for owners, or those appointed on owners' behalf, to control the excesses of management. The early discourse of governance (including Hung, 1998) largely reinforces the compliance motivated distant relationship between the board and the organisation itself - implicit in Llewellyn's (1931) prescient treatment of contracts. However, this atmosphere is at odds with that prescribed by both Pound (1995) and Sonnenfeld (2002) who call for a committed and engaged board to govern the corporation: phenomena often observed in black-box research conducted on exemplar case studies (Stablein, 2006). But more typically there is a distant relationship between the board and management, as is evident in the exercise of power over agenda setting (Peebles, 2010).

Not one, but two phenomena are postulated to evolve from the separation of the provision and control of wealth. The first is agency (Jensen & Meckling, 1976). The second phenomenon is the ensuing confusion between the two groups now supposedly responsible for organisational success: the board on one hand and management on the other. Attempts to assign distinct roles and responsibilities to the board began in 1966 with by the American Management Association (Kristie, 1997) and have continued (e.g., American Law Institute, 1992) ever since (Institute of Directors in New Zealand, 2012). These roles and responsibilities appear to be widely accepted, being endorsed by Hilmer (1998) and KPMG (2001) in the context of Australian and New Zealand business respectively. In contrast to these 'list' approaches is the argument (Cochran & Wartick, 1994; Taylor, Chait & Holland, 1996) that the board's contribution is strategic and focus is external. This latter argument is summed up by (Cochran & Wartick, p. 10) as governance being "strategy orientated whereas management is task orientated". However, this argument also suffers from being too narrow (Lockhart, 2012) as it incorrectly assumes that internally related activity is less than strategic, and not for the board. But regardless of the source of list of directors' duties many are largely compliance related and typically ignore strategy. The United Kingdom's Companies Act 2006, s. 172 provides a notable exception.

If boards are to be held responsible for performance then they need to shape the organisation's strategy: the mechanism through which boards actually add value as prescribed by both Huse (2007) and Nicholson & Kiel (2007). Henri Fayol (1916/1949) was the first to formally recognise the functions of management. In the context of strategic management the functions are typically better recognised as the establishment of direction (Bart & Baetz, 2001; Campbell & Yeung, 1991; Collins & Porras, 1994; David, 1989; Hamel & Prahalad, 1989, 1994; Pearce & David, 1987); scanning the environment (external and internal); establishing strategy; implementation; and, evaluation and control of the outcome. The suggestion being offered here is that in *all* boardrooms there is a simple division of labour, itself motivated by numerous forces, especially power (Kim, Pinkley & Fragale, 2005), between the board and management for the conduct and completion of each of these functions and the structure and profile of ownership.

Observations of practice suggest that there *is* a distinct division of labour between the board and management with respect to strategy and, importantly, the other functions of the strategic management process. But, it would be naïve to suggest that this division of labour is either constant across boards or consistent within a company in the medium term. The involvement of corporate boards in the strategic management process in New Zealand and Australia can be observed to follow Wheelen and Hunger's (2002), now seminal, rubric. Their range of board involvement in strategic management may also partly explain the variance reported in local empirical studies (e.g., Ingley & Van der Walt, 2001).

The strategic management process (or framework) through which corporate strategy is developed, implemented and subsequently controlled has been observed as a division of labour between boards and management (Lockhart, 2012). However, no single model has yet emerged, or could rightfully be expected to emerge. At one extreme boards have been observed to 'rubber stamp' proposals from management while at the other they have been observed to be the catalyst (e.g., Lockhart & Taitoko, 2005) for the development of corporate strategy. Under such circumstances the CEO has been observed to take a 'near project-management' role.

The results from black box research (Edlin, 2007; Martyn, 2008; Peebles, 2010; Crow, 2012; Crow & Lockhart, 2013) support the apparent, but highly variable, division of labour. Actively engaged and committed boards are observed to be entirely focused on enhancing business performance - while not always achieving that outcome. For example, the Brierley Investments-dominated board of Air New Zealand conducted a high risk exit strategy from Ansett in the late 1990s that resulted in the collapse of the subsidiary and near failure of the parent (Lockhart & Taitoko, 2005). That is not to suggest that boards are more inclined than management to contribute to failure, but it is indicative of how involved boards can be in corporate strategy.

Where the responsibility for performance is held by the organisation's governance, notably its board of directors, the division of labour concerning the strategic management process appears to be explicit (Lockhart, 2012). Such boards appear to take ownership of the strategic management process. Through a division of labour they allocate responsibilities to management for various functions, or parts of those functions as and when required. This concept of the division of labour overcomes Tricker's (1993) reflection that "organisations [were observed to have] peaked at the CEO" (p. 1). Considering the roles and responsibilities of governance and management - what it is that boards actually do; how they do it; and, why - in terms of a division of labour, provides a means through which numerous grounded contributions can now be explored in a far more orderly manner. Of interest to this discussion now is how and why *power* may be applied to allocate the division of labour between the board and management.

3. Power in the boardroom

The importance of good active governance was reinforced by Picou and Rubach (2006, p. 64) who, when asked if governance matters to institutional investors, stated "it appears that it does." Wong and Barton (2006, p. 75) hold a similar view stating that, "the issue of sound boards is also well to the fore because of their clear link to the cost of capital". In 2002 McKinsey's global investor opinion survey showed that equity investors would pay a premium of 20% to 40% for emerging market companies with strong boards of directors. More recently a study by Nam and Lum (2006) of the Asian Development Bank Institute found that South Korean and Indonesian companies whose board-effectiveness ranking rose from the median to the top quartile saw their market value increase by 13% to 15%. In South Africa, Mervyn King (2009), the judge who headed the drafting of that country's corporate governance code, observed that foreign capital flows to places that exude a perception of good governance (p. 75).

However, it is likely that good boards produce desired results by focussing on the right things to discuss. As Hendry (2005, p. S62) remarked, "the work of boards is not just about ensuring accountability for performance, important though that is. It is also, and primarily, about ensuring good performance". The need to explore the board management nexus – through which business performance is achieved – is, therefore, irrefutable.

To meet the demands of the global market place boards need open discussion and stronger follow-through, bringing to management fresh thinking (Campbell & Sinclair, 2009). However, they warn that this is not an easy task as board procedures are anchored and meetings, agendas and timetables typically followed a pre-set annual plan while attempts to make change are often resisted because of habit and established patterns of behaviour. These observations are supported by Peebles' (2010) study of agenda setting in the boardroom which provides an extraordinary insight into not only what gets discussed but *who* determines what gets discussed (see Lewis & Considine, 1999). His research provides a marked contrast to the earlier findings of Grady (1999) who commented that traditional boards put their focus on reviewing history, not creating the future. Peebles, through an extensive empirical investigation of directors on publicly listed boards in New Zealand (and Australia), observed that power cliques exist and that directors passively accept established governance systems and practices. It appears that directors favour acceptance amongst their peers rather than risk challenging them over ineffective contributions. Peebles (p. ii) also remarked that, "while there is a generally held belief among directors that the agenda is not subverted or hijacked there was no trace of proactive audit to ensure against that outcome". What wasn't rationalised at the time was the impact of power on subsequent performance (Peebles & Lockhart, 2011) nor the influence of power on the division of labour.

Derek Higgs (cited in Dulewicz, Gay & Taylor, 2007) listed the key areas of the non-executive board director role as strategy (to challenge and contribute to strategy development); performance (to scrutinise management performance and monitor the performance reporting); risk (to ensure financial information is accurate and control systems are robust and defensible); and, people (in areas of remuneration, appointment and succession planning). The difficulties researchers have in working with boards make it difficult to challenge conventional wisdom such as this (Dulewicz, Gay & Taylor). Peebles' (2010) research, where there was excellent access to top directors both through a survey questionnaire and integrated focus group meetings, brought up almost identical issues of what should constitute the focus of a good board in active governance. However, these results were overshadowed by power – who has power controls what gets discussed. And, as Peebles observed, it is rarely the board. The board agenda, and therefore, what gets discussed by the board was almost always found to be controlled by the board chair (23%); the CEO (32%); or, some combination of the chair and CEO (37%). Only in 4% of responses, verified by way of focus groups, did directors claim influence over the board agenda.

Useem and Zelleke (2006) observed that directors need to be decision makers in their own right, and to help a company choose the correct strategic pathway. McKinsey (2008) reported that only 46% of directors considered board meetings to be focused on value creation; had a clear agenda; focused on key issues; and, had present board members and executives with relevant expertise. They also remarked that:

> *although most corporate directors say they have good access to the CEO, CFO and COO, only about a quarter say that's true of their access to most other senior executives, many of whom are likely to have relevant expertise in areas such as talent management or the customer experience. (p. 7)*

Therefore, the competencies needed as a director, implicit in the preceding division of labour discussion, may never be brought to the boardroom if the agenda is not aligned with the company's strategic management process. Wheelen and Hunger (2002) attributed such lack of involvement by boards in a company's strategic management to passivity, or incompetent boards. In doing so, they failed to observe either directors adherence to the status quo - deference to peer acceptance, or power cliques in the boardroom. The strength of good governance process lies with individuals, a view reinforced by Gillies and Morra (1997, p. 73) who state that, "as many active directors have pointed out, it is individuals, not corporations who make decisions". However, the temptation of peer acceptance over effective collective decision making, especially when power resides elsewhere, has been demonstrated to be remarkably strong.

The enquiry surrounding governance as a division of labour between the board and management (Lockhart, 2012) was supported by numerous observations inside the black box. Neither power cliques nor passivity (Peebles, 2010) were observed in the black box studies quoted above. However, the considerable difficulty in obtaining access to the board room for such studies may suggest that these studies took place among outliers. Whether or not the researchers were exposed to behaviour modification by board members also remains questionable. Nevertheless, these are rare boards sufficiently confident in both their processes and business performance that silent observers were tolerated. Further, power should not necessarily be translated as an agency problem (Pye & Pettigrew, 2005) manifest at the board level. The discussion reflects the limited contribution that boards make to the agenda and, therefore, what gets discussed. Open debate over the division of labour for the strategic management process is unlikely. Whereas acceptance of extant processes is highly probable. The other limitation is that much of this latter research has been re-confined to public corporations (of which some were listed or their state owned equivalents). In this context both the division of labour and power over agenda setting appears to be more observable than that expected from unitary boards.

4. The role of owners

The voice of shareholders, owners, is another factor through which the board management nexus can be explored. Douma and Schreuder (2002) state that all major decisions are made by corporate officers (p. 110), but in doing so fail to recognise the owners' role, by way of the board of directors (Andersen, 2012). Andersen's view suggests that either the board of directors are well attuned to owners' aspirations, or in the case of smaller businesses, are the owners themselves. Separation of ownership from control only occurs when voting stock is "widely diffused" (Berle & Means, 1932, p. 7). Berle and Means were careful to distinguish between private corporations, where ownership and control are largely aligned, and quasi-public or public corporations where the separation of ownership from management occurs. They argued that it is only in these latter organisations that the interests of owners and managers are likely to diverge. Yet too often the governance literature reduces the owners' role to principal, assuming that the governance discussion relates entirely to public corporations. Again the unitary board appears to be ignored.

The rise of the investor public, and the diverse breadth of that group came about as more people developed wealth and surplus capital over and above their living needs. However, small shareholders wishing to link with major investors and share corporate profits argue they are disenfranchised or take second place to larger shareholder interests. These concerns have led to the rise of shareholder groups, such as, the New Zealand

Shareholders Association; Australian Shareholders Association; and, the increasingly influential SDK (Schutzgemeinschaft Der Kleinaktionäre). Therefore, small investors (minority owners) are seeking to influence business outcomes by way of their collective voice both across and within organisations.

Dealings in monthly meetings (but often on a less regular basis for board subcommittees) are seldom detailed and circulated to shareholders, except of course where shareholders are owner-directors as occurs in the private corporation. These deliberations are largely hidden for actual board discussion is seldom, if ever, recorded verbatim being minuted in summary (Peebles, 2010). Only board resolutions are likely to be documented and informal discussions are unlikely be recorded. This means that issues and the process of debate will largely go unchallenged by shareholder forums of quasi-public and public corporations unless circumstances demand a special general meeting or arise for general consideration at an annual general meeting. Under The Sabanes-Oxley Act of 2002 this now differs for the United States as quarterly reporting and disclosures are mandatory. But despite Sarbox secrecy is largely enjoyed by directors (Leblanc & Schwartz, 2007)

Accepting that the board's role is to ensure enduring value creation for the business owners then the board agenda should be expected to reflect that focus (Peebles, 2010). In the absence of owner-directors, as is the case with Berle and Means' quasi- and public corporations, the responsibility to owners lies firmly with the board. Decisions concerning "organisational goals and strategies" (Andersen, 2012) must be taken by board of directors.

5. Conclusion

Governance is observed to include the critical division of labour between the board and management; implicit power cliques in the boardroom and between management and the board; and, the aspirations of the company's owners. But if the directors themselves do not control the focus of their debate, succumb to the intrinsic need for peer acceptance and disengage from business owners how can they be expected to add value? It is appropriate to ask whether or not directors are active or passive in *each* of these board processes. Chairman Irving S. Olds of U.S. Steel (1940-1952) commented that directors were like "parsley on fish - decorative but useless" (cited in Kristie, 2009). It also explains the all too common phenomena of why when a problem surfaces, where was the board? As MacAvoy and Millstein (2004, p. 7) said of the Enron crisis, "but many, including the Congress, still ask, 'where was the board of directors, and why didn't it restrain management before it brought Enron down?'" And, as has been observed in New Zealand with Fonterra's 2013 food scare, the Board remained silent for eight days after the problem came to the public's attention: Where was the board?

Directors must set their own agenda or they cannot control the focus of their discussions and add value to the company by way of the strategic management process. Board agendas need to take responsibility for that process and met the aspirations of owners. But considerably superior knowledge is held by the CEO, and even the most well-intentioned CEO has a real power advantage over non-executive directors. Understanding the power of various groups within an organisation is crucial to understanding what happens in everyday affairs. A perfect process should, however, be impartial and not subject to varying power surges and influences. If boards drive their own agenda process, and thereby define the space they wish to occupy, they can plan to meet the value add focus that is supposedly their prime purpose. Of course, this assumes that directors understand and accept this is their role.

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