Towards a re-conceptualisation of governance, via strategic decision-making and performance

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Abstract

Agency theory (Jensen & Meckling, 1976) has provided the theoretical basis for most governance research and recommendations for practice over the past four decades. It is predicated on a clear separation of the roles of governance and management, and the assignation of responsibility and accountability to the board of directors to represent (and protect) the interests of the shareholders. In the last two decades, as the responsibility for business performance has moved from the CEO to the board, many aspects of governance have been investigated including structure, composition, behaviour and practice. The research agenda has been largely dominated by hypothetico-deductive science employing large data sets and conventional multivariate analyses. Correlations between observable variables of interest have been identified, and rich descriptions have been produced. However, no robust explanations, of how boards influence company performance, have emerged (Bozec & Bozec, 2012) to date.

An inspection of corporate failure data and data from the observation of boards in action suggests that the separation of governance and management provides no guarantee of business success. Indeed, it has been the source of much confusion (Bradshaw & Hayday, 2007). The various defensive screens that have been erected by boards in response to the failures – including claims of paucity of information; poor implementation of strategy; and, management fraud – expose shortcomings in both theory and practice. Therefore, the question of whether a clear separation between governance and management, as espoused by agency theory, is the best model through which to achieve the organisation's aims, needs to be revisited.

The aim of this paper is to explore governance through the lenses of accountability and performance; make causal inferences (King, Keohane, & Verba, 1994); and, take tentative steps towards a new conceptualisation of governance. The value that boards contribute to company performance appears to lie in their active and ongoing involvement in the strategic management process. The consideration of strategic options; making of strategic decisions; adequate monitoring of strategy implementation; and ownership of the governance process all seem to be significant (Bonn & Pettigrew, 2009; Crow & Lockhart, 2013; Lee, 2011; Peebles, 2010). Further, company performance appears to be enhanced when the division of labour between board and management (Lockhart, 2012) is clearly defined and efficiently implemented, and both groups are actively engaged in the process of governance. Extant theories of governance, which describe a clear separation between governance and management, and emphasise monitoring and control, appear to be inadequate.

Keywords: governance, accountability, strategic management, agency theory, performance

1 Introduction

The topic of governance has been investigated by many researchers in recent decades, as the search for business performance has increasingly shifted from the CEO to the boardroom (Brown & Caylor, 2004). Research into the impact of governance on company performance has proliferated (Moore & Reberioux, 2011; Vandewaerde, Voordeckers, Lambrechts, & Bammens, 2011), particularly since the procession of high profile company failures of the early 2000s. Boards of directors (henceforth, boards) provide a vital link between company owners and managers (Fama & Jensen, 1983). Consequently, many structure and composition variables have been studied (Boone, Casares Field, Karpoff, & Raheja, 2007), in an attempt to identify the best configuration through which to minimise agency costs (Agrawal & Knoeber, 1996) and, therefore, supposedly optimise company performance. Governance has proven to be difficult to study however (Adams, Hermalin, & Weisbach, 2010). Researchers have experienced epistemological limitations and methodological challenges (Mir & Watson, 2001), and conclusive results remain elusive (Lee, 2011; Pugliese et al., 2009).

Consequently, the emperor remains "for the most part rather naked" (March & Sutton, 1997, p. 702), and the discovery of an explanation of how boards influence company performance is yet to be achieved (Abatecola & Poggesi, 2010; Strange, Filatotchev, Buck, & Wright, 2009).

The value that boards contribute appears to lie in their active and on-going involvement in strategic thinking and management processes; strategic decision-making; and, the monitoring of strategy implementation, because governance is an activity not a structure. Further, board activities are emergent. They cannot be adequately explained through the reduction of the roles or the activities of individual directors or even governance attributes. Governance is a complex, socially dynamic phenomenon (Byrne & Ragin, 2009) which can only be studied holistically, and causality in socially dynamic phenomena is 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 (Wynn & Williams, 2012), and underlying causal powers and mechanisms to be exposed (Tsoukas, Ackroyd, & Fleetwood, 2000). Miles and Huberman (1989) showed that it is possible to postulate causal influence in social science research without resorting to statistical measures, provided data is gathered from multiple settings. This research used an iterative deductive-inductive design (Aichelburg, Sexl, & Bergmann, 1979; Dubois & Gadde, 2002) and quantitative and qualitative data collected from several organisations (King, et al., 1994) including interview data and the direct observation of boards *in situ* (Leblanc & Gillies, 2005), in order to gain a deep understanding and take tentative steps towards exposing the underlying powers and mechanisms that can cause outcomes.

This paper is organised as follows. First, the agency literature is summarised, to which a critique is provided. A description of the research method is then provided. The relationship between strategic decision-making and performance is discussed, and a re-conceptualisation of governance is presented. Finally, conclusions and opportunities for future research are presented.

2 The separation of governance and management

The catalyst for the emergence of corporate governance (and especially boards) was the new model of company that emerged in the anglosphere in the late 19th Century. Mechanisms were required to protect the interests of investor owners, as they were not directly involved in the day-to-day operation of the company (Berle & Means, 1932). Boards were established as a proxy, to monitor the activities and performance of management on behalf of the owners (Fama, 1980; Fama & Jensen, 1983). Most of the governance research conducted to date has been influenced by the seemingly straightforward agency theory (Aherns & Khalifa, 2013; Daily, Dalton, & Cannella, 2003; Jensen & Meckling, 1976), which reduces governance interaction to just two separate parties (the agent and the principal). The theory has been criticised as being "simplistic" (Judge, 2011, p. 293), because it overlooks group dynamics (Roberts, McNulty, & Stiles, 2005); the motivations of managers (Davis, Schoorman, & Donaldson, 1997); and, the social reality of boards (Knapp, Dalziel, & Lewis, 2011).

The separation of governance and management (Fama & Jensen, 1983) can lead to conflict (Holmstrom, 1982; Lubatkin, Lane, Collin, & Very, 2005), because the delegated agent's actions can depart from those required to maximise the principal's returns (Fama & Jensen, 1983). However, the establishment of appropriate structures and control mechanisms to align management behaviour with the expectations of owners can supposedly mitigate the agency problem (Daily, et al., 2003) and, therefore, ensure the financial success of the company. Consequently, much of the governance research conducted to date has explored structural, composition and, to a lesser extent, behavioural attributes of governance. Numerous variables that have appeared to be significant in a normative input-output sense have been isolated. These include board size (Coles, Daniel, & Naveen, 2008); CEO duality (Dalton & Kesner, 1987); composition (Nicholson & Kiel, 2007); gender (Simpson, Carter, & D'Souza, 2010); diversity (Adams & Ferreira, 2009); non-executive directors (Cadbury, 1992); behaviour (Larcker & Tayan, 2011); practice (Adjaoud, Zeghal, & Andaleeb, 2007; Balgobin, 2008); and, power (Peebles, 2010). Correlations between observable variables of interest have been identified, and rich descriptions have been produced, however, no robust explanations have emerged.

Agency theorists claim that an association exists between independence and performance, however, this assertion is not well supported in the literature (Daily, et al., 2003). The clear separation between owner and manager described by Fama and Jensen (1983) has been found to be unrealistic (Audretsch, Lehmann, & Plummer, 2009; Uhlaner, Wright, & Huse, 2007). Further, agency theory can be falsified (Popper, 1972), as evidenced by the contradictory results published to date. No consistent improvements in, nor predictions of, company performance (Dalton, Daily, Certo, & Roengpitya, 2003;

Demsetz & Lehn, 1985) or value creation (Kraus & Britzelmaier, 2011) as a result of agency mechanisms have been reported. Structures and controls do not appear to guarantee effective governance, nor can they assure company continuance. They are observed to be insufficient in averting the corporate collapses of the early 2000s; the global financial crisis of 2008–2009 (Conyon, Judge, & Useem, 2011); and, some of the more recent failures of governance in New Zealand[1]. This is not surprising because empirical knowledge about isolated attributes cannot credibly predict the future performance of social phenomena (Quine, 1991).

The dearth of any conclusive evidence suggests that researchers now need to move beyond the assumption that the processes of governance and management are independent and that governance can be reduced to a set of discrete variables; the study of isolated structural and composition attributes; and, the use of large data sets and multivariate analyses if a credible explanation of the governance–performance relationship is to be discovered. An inductive theory-building approach, grounded in reliable empirical data (Glaser & Strauss, 1967) and supported by normative justification (Christensen & Raynor, 2003) and a critical realist worldview (Bhaskar, 1975), may provide a path forward (Crow, Lockhart, & Lewis, 2013).

3 Research method

A multiple-case study approach centred on actual boardroom observations of two quasi-public (Berle & Means, 1932) high-growth companies, supplemented by data gathered from additional secondary and tertiary sources, was used to conduct this research. The CEOs and board chairs of the two companies were interviewed independently of one another using a semi-structured format. One year of both performance data and governance data[2]; company records; and, press releases and other public information were reviewed. In addition, four other CEOs and two other board chairs were interviewed, to enhance the interpretation of the subsequent analysis. Anonymity was a necessary condition of conducting this research. Therefore, the names of contributors and all identifying information of the companies studied – other than being domiciled in New Zealand – and the other contributing executives remain undisclosed.

Data quality was enhanced through the use of respondent validation and triangulation. A pictorial timeline framework (Lockhart & Taitoko, 2005) was used to consolidate and analyse data in order to expose associations and relationships. An audio recording was made of each boardroom observation and executive interview, so that handwritten notes could be checked and verified. An iterative deductive-inductive process (see Tsoukas, et al., 2000) was used to identify governance roles, task characteristics and functions; categorise circumstances; infer underlying causal powers; test assumptions; identify anomalies; and, take tentative steps towards a realist re-description. This realist view enabled the locus of research to move from an exclusive focus on board structure and what boards do, to the question of what they are doing and likely to be capable of doing.

4 Strategic decision-making and performance

The selection and implementation of strategies that enable a company to compete effectively (Ahenkora & Peasah, 2011) appears to be crucial to value maximisation (Simons, Davila, & Kaplan, 2000). Further, the development of strategy is now recommended as being a major task of the board (Huse, 2007). Therefore, effective governance is perhaps best understood through the strategic decisions made by the board. While considerable strategic decision-making research has been reported in the management and psychological literature (Steptoe-Warren, Howat, & Hume, 2011), this literature is relatively devoid of research into the board's role in strategic decision-making (Lockhart, 2010; Pugliese, et al., 2009). Although the relationship between governance and performance has been postulated on several occasions. Active engagement in the form of leadership in the development of strategy (Wheelen & Hunger, 2006), strategic thinking, and the making of strategic decisions in the context of approved strategy (Crow, 2012; Pugliese & Wenstop, 2007) appear to be significant. Notwithstanding this, agency theorists largely argue that strategy is the

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[1] Examples include the collapse of Dominion Finance and several other finance companies; Christchurch City Council losing the power to issue building consents; Solid Energy becoming insolvent; and, the Fonterra botulism scare.

[2] Governance data: meaning confidential board reports and minutes of board meetings

domain of management, and that the board's role is to review and ratify the strategy proposed by management (Andrews, 1980).

A proactive involvement by boards in the strategy development process and assessment of strategic options is apparent in the data. The board appears to improve the quality of environmental scanning; minimise the chance of selecting poor strategies; and, improve decision-making. Knowledge about the business and the assertiveness of individual directors appear to be important (Anderson, Melanson, & Maly, 2007; Bongjin, Burns, & Prescott, 2009; Kerr & Werther, 2008; Levrau & Van den Berghe, 2007; Maharaj, 2009), even though the CEOs interviewed during this research believed that their boards did not necessarily understand the drivers of their respective company's success (Carter & Lorsch, 2003). The interviewees also reported that the making of strategic decisions can be challenging, particularly in high-growth companies (Lim, 2012), because decision-makers typically do not have access to all the information required to make suitably informed choices. Management was observed to control the board's agenda in many cases (Peebles, 2010; Useem & Zelleke, 2006), which was observed to limit the flow of relevant information. Poor decisions – or decisions not made because items were not raised by management to the board or the board asked the wrong questions – were also observed.

The data suggests that there is a fine line between the board having an active involvement in strategic matters (seen as desirable), and the board being seen to impinge on management's delegated responsibility to implement strategy and operate the business. All of the CEOs interviewed claimed to control the process of strategy development, whether the board was actively involved or not. Interestingly, two interview participants suggested that increased involvement and interaction between the board and management can lead to interference and loss of objectivity in oversight when the strategy is implemented (e.g., Anderson, et al., 2007). While these concerns do not appear to be widespread, it may be possible to allay them by ensuring the board–management boundary is well defined, via a board-led discovery process, to ensure that an appropriate division of labour (Lockhart, 2012) is established. Notwithstanding these challenges, the calls for boards to increase their involvement in the process of governance and in strategic decision-making have become more common (Tricker, 2009), although remain far from universal (Zattoni & Pugliese, 2012).

5 Towards a strategic theory of governance

Realist ontology – that a real world exists independent of our knowledge of it – provides an opportunity to reconceptualise governance and construct a meta-theory. Boards have the power to develop strategy and make strategic decisions, whether they actually do so or not. It is, therefore, logical to assume that they have the capability for strategic thinking. The data collected from boardroom observations in this study indicates that when strategy is developed, decided upon and implemented in the context of the sustainable purpose of the organisation; performance is reported and monitored; and, the board and management are actively engaged together in the process of governance performance outcomes follow.

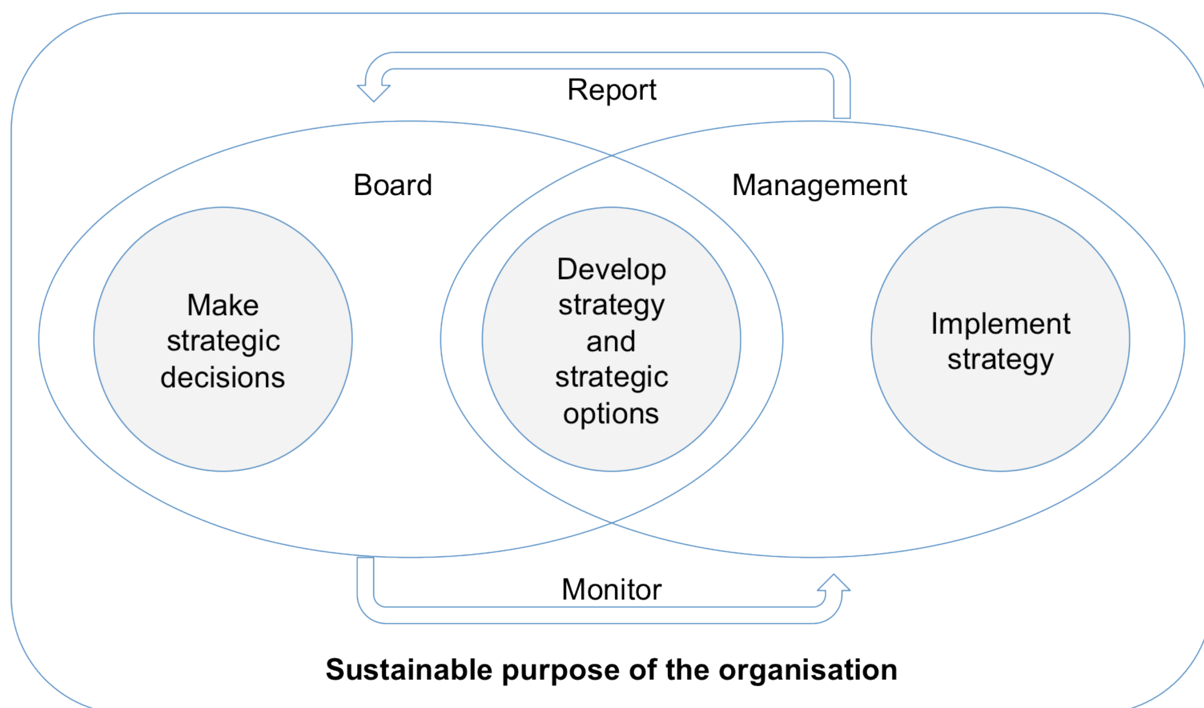

Figure 1: A model of strategic governance

This tentative proposal, of a strategic theory of governance, suggests that governance and management is nothing more than a division of labour between the board and managers, to develop, decide and implement strategy, in order to achieve the sustainable purpose of the organisation. Restating governance and management in this way appears to expose the elusive causal mechanism and underlying causal powers that explain the relationship between governance and performance, and the impact boards can have on company performance. The underlying causal powers appear to be innovation, engagement, cooperation, competence and control, each of which seems to be necessary to explain the causal mechanism. This theory of governance is grounded in the strategic management literature and organisational theory, and a deep understanding of the data and organisational context, and was exposed via critical realism (Crow, et al., 2013).

6 Conclusion

The value that boards can contribute to company performance appears to lie in their active and ongoing involvement in the strategic thinking and strategic management processes – through the consideration of strategic options; the development of strategy; the making of strategic decisions; and, the adequate monitoring of strategy implementation and subsequent performance. Company performance appears to be enhanced when the division of labour between board and management is clearly defined and efficiently implemented, and the board activates the underlying causal powers of innovation, engagement, cooperation, competence and control. Further, the boards of successful companies appear to enjoy strong relations with management (Boyd, Haynes, & Zona, 2011). They also seek to make decisions through consensus (Baranchuk & Dybvig, 2009) to achieve strategic goals. Under such circumstances the amount of political interplay between the individuals involved, in roles of both governance and management, is expected to be minimal.

This context-sensitive theory of governance should enable shareholders, the board and management to begin to understand the actual governance characteristics (i.e., contexts, processes and actions) that enable increases in business performance. Once boards understand the underlying causal powers and the mechanisms that can be activated, increased performance is not only possible, but potentially sustainable. The strategic theory of governance proposed in this paper is preliminary and tentative. A more comprehensive three-year longitudinal multiple-case study, of two high-growth companies, is now underway. The analysis of data and results of this research will inform a doctoral thesis, and enable the proposals described in this paper to be refined or rejected.

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