Corporate Governance, Board of Directors, and Firm Performance

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The relation of corporate governance (CG) and firm performance, where performance is interpreted broadly to include not only economic profits but also best management practices, is a central issue confronting CG scholars. In particular, the structure and effectiveness of corporate boards continues to draw intense scrutiny, in part because of the tension between their legal role and their actual performance. In most countries, the boards of directors serve as the legal representatives of and have the fiduciary responsibility to monitor management and serve the interests of shareholders (e.g., Black, 2000; Van Den Berghe and Levrau, 2004). Meanwhile, board responsibility is generally interpreted to include not only the monitoring role of boards but also the expectation that boards will provide knowledge, advice, and business networks to aid management in improving firm performance (Harris and Raviv, 2008; Pugliese et al., 2009; Zahra and Pearce, 1989), and will effectively represent shareholders in designing management compensation (Kumar and Sivaramakrishnan, 2008). However, following a wave of high profile corporate scandals *globally* in the last two decades, the determinants of firm performance and the role of boards and national governance characteristics remain intense areas of CG research.

In this issue, we have contributions that address various aspects of these issues both at the level of the firm and at the level of national governance characteristics. The first paper, by Mather et al., examines the relation of director characteristics, such as reputation and financial expertise, to the *quality* of managerial earnings forecasts (MEFs). Higher quality MEFs, for example those that are more accurate and specific or are less contaminated with bias, clearly improve transparency and reduce agency costs, i.e., are consistent with notions of best management practices or superior firm performance. Using some unique aspects of Australian securities laws that mandate “continuous” disclosure of price-sensitive information, the paper examines the association between board characteristics and the quality of MEFs. They find that the relation of positive board characteristics, such as independence, good reputation, and financial expertise, to higher quality MEFs is moderated by the growth opportunities available to the firm. Previous research on this topic had been unable to find a clear and positive association between board independence and higher quality MEFs; indeed, some studies found a negative association between superior board characteristics and MEF quality. However, the significant innovation in the study by Mather et al. is that it examines the influence of firms' investment opportunities on the incentives of the board. It is a common assumption in the agency literature that firms with higher growth options are more subject to agency costs from adverse selection and moral hazard. The authors hypothesize that independent, reputable, and expert directors will recognize the higher value of information transparency in high growth option firms, and will therefore be more diligent in mitigating the agency costs by ensuring the quality of MEFs. An analysis of archival data supports their hypothesis. This significance of this study is that it shows clearly the importance of considering the incentives of the board and how these are related to other non-governance related characteristics.

In a related vein, the second paper by Farrell et al. examines the influence of both governance and non-governance related firm-level characteristics on decisions by management to strategically "manage earnings" through share repurchases. In contrast to high quality MEFs, these earnings management related activities obfuscate the true economic picture of the firm and increase asymmetric information. Using a large sample of 2,225 (unique) U.S. firms suspected of earnings management over a ten-year period from 1997 to 2006, these authors find that growth firms are less likely to use share repurchases for earnings management purposes. The hypothesis here is that growth firms have better investment opportunities and, therefore, lower amounts of excess cash available for use in strategic earnings management activities. Moreover, because the firm's board must approve share repurchase programs, the quality of corporate governance is implicated in the propensity to engage in earnings management, other things held fixed. The study finds that firms with a more independent board, a separation of the roles of CEO and chairman of the board, higher CEO ownership or a low entrenchment index (E-Index) are less likely to engage in earnings management. Here again we see that while many conventional CG measures come into play in affecting firm performance, the effects of those variables is modified by the quality of investment opportunities available to the firm.

The third paper, by Rost and Weibel, revisits the determination of CEO executive compensation, which has been a subject of a very large literature, from a fresh and especially interesting perspective. They argue that current executive compensation practices can be viewed as infringing the basic social norm that compensation should be fair. There has been a worldwide explosion in CEO compensation in the last two or three decades (Walsh, 2008). For example, CEOs in many large public companies now earn more than 500 times the salary of the lowest paid employee in the firm. A major factor in the growing disparity of executive and no-executive compensation has been the increasing use of stock options in executive compensation, and in most firms only a small proportion of employees have access to such options (Frydman and Saks, 2010). While these compensation trends have been evaluated in the literature from a variety of perspectives (Weisbach, 2007), the role of "subjective, judgmental and socially interactive processes" (O'Neill, 1999) in executive compensation has received little attention. The study by Rost and Weibel makes an important contribution by developing the relation of social norms to compensation, and then using a vignette-survey with a representative sample of Swiss citizens to document several novel results. The authors develop a model to "adapt and contextualize" social norm theory to the CEO compensation context. The model clarifies how individual differences, for example relating to status attributes and moral development, underlie differing perceptions of "norm-infringement," and how these, in turn, lead to the propensity to punish firms with norm-infringing CEO pay practices. Their data support the model. In particular, individuals with low-status attributes and individuals with highly developed moral views are more likely to be resentful of unequal pay practices and, importantly, are willing to punish norm-infringing compensation practices, especially in the presence of low-cost protest actions. However, individuals with sufficiently high feelings of deprivation are willing to consider punishing norm-infringement even if the protest actions impose high individual costs. This study introduces, in useful and illuminating way, an important dimension in the executive compensation debate that has heretofore been missing in the literature. It will be fascinating to see how further research builds on this study to develop the important interaction between CG and social norms.

As noted by Adams et al. (2010), there are two fundamental issues relating to boards: First, what are the determinants of the structure or composition of boards? Second, what are the determinants of board performance (or actions)? The fourth paper, by Sur et al., tackles the first issue; they examine the relation of ownership structure, specifically the distribution of different types of investors or shareholders, to board composition. This is a novel perspective because the previous literature has largely analyzed the determinants of board composition (e.g., insider versus independent) based on characteristics specific to the CEO, or the directors, or the firm. That owners' preferences or types (e.g., institutional versus family-owned) would also play a role is intuitively plausible, but has been rarely explored in the literature. Using archival data for U.S. firms, the study finds that there is relation of board composition (that is, insider, affiliated, or independent) with the ownership configuration (institutional, corporate parent, family-entrepreneur control), even after controlling for the covariates considered in the earlier literature. Clearly, the different owner types have distinct concerns and expectations from the board, based on their specific objectives and constraints. For example, institutional investors are focused on abnormal returns, relative to the systematic risk of the firm, because mutual and pension fund managers (for example) are compensated based on market benchmarks. On the other hand, family-owned or corporate owners may look to the directors for expertise and other resources for the firm. Thus, a contribution of the paper is to show that board composition and structure cannot be understood from any single theoretical lens; rather, the heterogeneity in ownership preferences requires multiple theoretical lenses: for example, both an agency-theoretic view and a resource-dependency perspective. Moreover, the paper is novel in emphasizing that boards and outside investors may be complementary with respect to corporate governance, in contrast to the substitutability between owner and board monitoring that is emphasized in the literature. Indeed, the results of this study appear closely linked to the “clientele” approach to tax and payout policies recently emphasized in the finance literature (Baker and Wurgler, 2004). There the idea is that firms tailor their financial policies to match the preferences of their dominant owner-types. Similarly, the Sur et al. study seems to suggest a clientele approach to board structure that could be potentially quite fruitful.

While the first four papers take a firm-level perspective, the fifth paper, by Aguilera et al., explores the interaction between firm- and national-level governance characteristics in understanding the relation of CG to firm performance. Though a creative use of fuzzy set (or qualitative comparative analysis), the study demonstrates the heterogeneity in the bundles of corporate governance practices that generate high firm performance. One of the most powerful insights of the study is that individual CG practices within a bundle need not be related to each other in a monotonic fashion, nor is there necessarily a substitutability relationship between corporate governance practices from the viewpoint of generating high firm performance. Indeed, at the level of the firm, there is a rich variety of functionally equivalent governance “paths” to higher performance. This substantially expands the scope of effective governance mechanisms available to firms, and cautions policy makers at the national level against forcing simple and homogenous governance mechanisms on firms. Moreover, this view suggests that firms should carefully examine the complementarity, as much as the substitutability, among various practices in designing their CG mechanisms.

We hope that the papers in this issue will provide impetus to move CG research forward in some important dimensions. The theoretical CG literature still largely either views the board as a selfless and perfect agent of shareholders or as co-opted by the CEO (Bebchuk and Fried, 2004). Much work remains to be done to construct theoretical models of board behavior and incentives that take into account the imperatives of individual directors (Cyert et al., 2002; Huse et al., 2011). The empirical findings presented in this issue, such as those in the studies by Mather et al., Farrell et al., and Sur et al., should provide a rich resource for theorists to develop models that incorporate some salient aspects of firms and their ownership structures that influence board structure and behavior.

Such models will help generate other refutable predictions that refine and deepen our understanding of the fundamental issues regarding boards that are raised, for example, by Adams et al. (2010). Similarly, the role of social norms in the determination of executive compensation is plausible intuitively, and the paper by Rost and Weibel does a very nice job of providing empirical support. This study should help motivate refinement and extension of existing theoretical frameworks for the determination of executive compensation and lead to better empirical design on this issue; for example, empirical researchers need to develop strategies to address the potential bias from excluding social norm based variables from the empirical specifications regarding managerial compensation. Finally, the study by Aguilera et al. breaks new ground in the application of qualitative comparative analysis for understanding the design of both firm- and national-level governance mechanisms for high firm performance.

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