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Good Governance driving Corporate Performance?

A meta-analysis of academic research & invitation to engage in the dialogue

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Abstract

Purpose
This white paper provides insight into the relationship between good governance and corporate performance. Governance variables that are scientifically proven to contribute to corporate performance are identified and its impact is assessed. They may provide guidance for business as usual practices that will help remediate key challenges.

Design/methodology/approach
The white paper is a joint effort between Deloitte and Nyenrode, combining perspectives from both scholars as well as the corporate community. The supporting research includes an analysis of over 59 academic articles published in the last 10 years from highly ranked scholarly journals in the field of management on the relationship between governance and performance.

Conclusion
The paper provides evidence for the correlation between several governance variables and corporate performance. These variables include:

- Board independence
- Board diversity
- Remuneration
- CEO characteristics
- Oversight
- Ownership structure

Research implications
The research also revealed some discrepancies between governance variables proven to contribute to corporate performance and the topics highlighted in the public debate on corporate governance. For example, the culture of an organization, and risk management practices, are rarely studied as a corporate governance variable impacting performance, while they are increasingly important topics in the corporate governance debate.

Practical implications
The overview, best practices and dilemmas provided in this white paper serve as input for the ongoing dialogue on enhancing corporate governance.

Preface

Welcome to the first joint white paper of the Deloitte – Nyenrode Research Program investigating the relationship between good governance and corporate performance.

This white paper provides insight into the relationship between good governance and corporate performance. Governance variables that are scientifically proven to contribute to corporate performance have been identified by analyzing academic research. This provides good practices and guidance identifying and addressing key challenges for Boards and directors.

Good practices and dilemmas

In governance there is no one size fits all solution. The best approach will depend on the organization's particular circumstances. Our goal is to assist Boards and directors with identifying the governance issues that really matter, provide good practices and guidance, and help promote a dialogue to identify and address dilemmas and improve decision-making.

Corporate governance consists of various variables that interact with each other and influence the organization's performance, each in their own distinctive way. Boards and directors are consequently faced with many dilemmas as they seek the right governance approach that matches their organization.

This white paper presents the governance variables that have a proven correlation with corporate performance. Good practices are identified and recommended. They will provide specific guidance to address key challenges.

Meta-analysis

To develop this white paper a meta-analysis was performed on academic research published between 2006 and 2016 in the five highest-ranked academic journals according to the Association of Business Schools ("ABS") ranking. The learning of the respective studies were analyzed and its results summarized

Joint effort

This white paper is developed as a joint effort between the Nyenrode Corporate Governance Institute and Deloitte Governance Services. By combining insights from scholars and the corporate community, actionable good practices, and guidance with identifying and addressing related dilemmas have been derived.
The research from this white paper will be used for further action-based research. Deloitte and Nyenrode invite Boards and directors to engage in the dialogue on governance and performance.

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Reading guide

1. Introduction to Corporate Governance
2. Governance and Performance in Academic Research
3. Dilemmas
4. Conclusion & Next steps

Appendix: Methodology & Database

Research Program

Deloitte and Nyenrode aim to contribute to the dialogue on good governance. We aim to explore good practices for Boards, provide guidance to identify and remediate dilemmas with the purpose of improving corporate performance.

Interpretation of main concepts as applied:

- Performance: long-term corporate value creation.
- Boards: governance body having oversight, for which the legal nature may differ based on the country of residence.
- Good governance: those elements that a board can influence to be in control of the business and corresponding results, enabling enhanced performance and accountability.

Introduction to Corporate Governance

Crises and scandals in the past decades triggered global interest in corporate governance, which resulted in an increasingly growing regulatory environment. Did this lead to more effective corporate governance and improved performance?

"The board is responsible for sharing a culture that is focused on long term value creation of the company and its business."

Jaap van Manen
Chairman of the Dutch Monitoring Committee

The behavior of managers can have a great impact on the performance and value of a company. Corporate governance is a way of handling "the separation of ownership and control", where managers of corporations may not have incentives to act in their shareholders' best interests[i]. Corporate governance as a concept includes the separation of roles and responsibilities, communication channels, and behavior between shareholders, board(s) of directors (both executives and non-executives) and the CEO.

Different schools of thought

There are several schools of thought describing the dynamics of corporate governance. Most scholars use the agency theory, but stewardship theory and stakeholder theory are also used to explain the dynamics between the different stakeholders in a company[ii]. These three theories are not mutually exclusive or collectively exhaustive, but they provide fundamental explanations to many of the findings in our research into governance and performance.

Agency theory

Agency theory assumes the core friction is the conflict of interests between the different parties involved in the company. An agency problem exists if a principal, such as the shareholder, employs an agent, such as the CEO and his/her executive team, to lead the company on the principal's behalf[iii]. Agency theory assumes that managers and shareholders are expected to have potentially conflicting interests.

Following agency theory, corporate governance, in the form of rule setting, monitoring and incentive and sanctioning mechanisms, is needed to align the interests.

Stakeholder theory

Stakeholder theory assumes the core friction is that good performance of companies depends on the contributions of many different parties. These stakeholders – shareholders as well as other parties - all have a stake in the company and can choose how to prioritize their stakes based on the information they have about the company. It is the responsibility of the management to balance all these interests[iv]. At the same time the stakeholders will try to influence management to meet their interests, goals and expectations.

Following stakeholder theory, corporate governance is needed to make sure that the voice of stakeholders is heard and that information about the company is distributed equally to all stakeholders.

Stewardship theory

Stewardship theory assumes that management should put the long-term best interest of a group ahead of the individual's self-interest[v]. Stewards, unlike agents in the agency theory, consider their interests to be aligned with the interests of the corporation and its shareholders. In addition, managers as stewards are in the best position to maximize the interests of stakeholders, including shareholders, since

they are most familiar with the dynamics of corporate strengths, weaknesses, opportunities, and threats[vi].

According to the stewardship theory, corporate governance in the form of selecting and training competent and trustworthy managers is required to commit all parties to work towards a common goal without taking advantage of each other.

Governance regulation

In 2001, the Enron scandal marked the beginning of an era in which corporate governance of in particular listed companies became a global discussion. A chain of regulatory events defined the corporate governance debate to a large extent.

Driven by the interests of public stakeholders several governance regulations and codes have been initiated globally. The primary goal to impose good behavior on listed (and non-listed) firms. Today we have 102 distinct corporate governance codes[vii].

Revision of the Dutch Code

In the Netherlands, the first principle-based regulation on governance was the corporate governance code for listed companies and their shareholders set up by the Tabaksblat Committee in December 2003. Since then the Dutch code has been revised several times, becoming increasingly more comprehensive.

Currently the Monitoring Committee led by Jaap van Manen is revising the Code which will be structured around governance themes and no longer per role within the organization, emphasizing the most important governance principles according to the committee. Amongst these principles are: A greater focus on long-term value creation, reinforcement of risk management, introduction of culture as acritical part of corporate governance and quality requirements for the "comply or explain" statements.

Most of these themes are already part of the current code. What is new is the introduction of, and emphasis on, culture as an explicit aspect of corporate governance: "The board is responsible for creating a culture that is focused on long term value creation of the company and its business. The supervisory board oversees the activities of the executive board in this regard"[viii].

The revised code provides a clarification of the quality required under the "comply or explain" mechanism, asserting the board's accountability for how the code is being applied. The board must be transparent when deviating from the recommended best practice. In doing so they should explain their alternative course of action and help stakeholders understand how it leads to better governance.

Global context

Best practices and principles stated in corporate governance codes emerge around the globe and can be recognized in several international codes. Like many, the Dutch Code, is influenced by the international context of governance regulation. For instance, the South African King IV Code of March 2016 already mentions the principles of culture and long-term value creation and the UK Code of 2014 references risk appetite as an important best practice. Recent revisions of the codes in Spain, Japan and Italy have impacted the Dutch revision as well. Even in the US dialogues are initiated by a group of leading executives and representatives from the asset management sector to discuss the need of a principle based corporate governance code[ix].

Does good governance actually enhance corporate performance?

There is a clear trend of improvements in governance codes and corresponding best practices. Whether they actually improve governance practices, and company performance, is less apparent.
The research performed for this white paper specifically focused on identifying governance mechanisms that have a proven impact on enhanced performance, regardless of whether they are marked as a good practice in regulation or codes. The results provide practical guidance for company directors, as well as a useful guidance for the people empowered with formulating governance regulation an codes.

Status of the NL Governance Code

At the time of publication of this white paper the proposed revision of the Dutch Code had been published. No final version was available yet.

After publication, the final version of the revised code will take into effect as per 1 January 2017.

Governance and Performance in Academic Research

The relation between governance and performance is widely researched, but often in a very specific context and with different results. Based on a comprehensive meta-analysis we provide an overview of those variables that really matter in driving performance.

'Good' governance leads to better performance

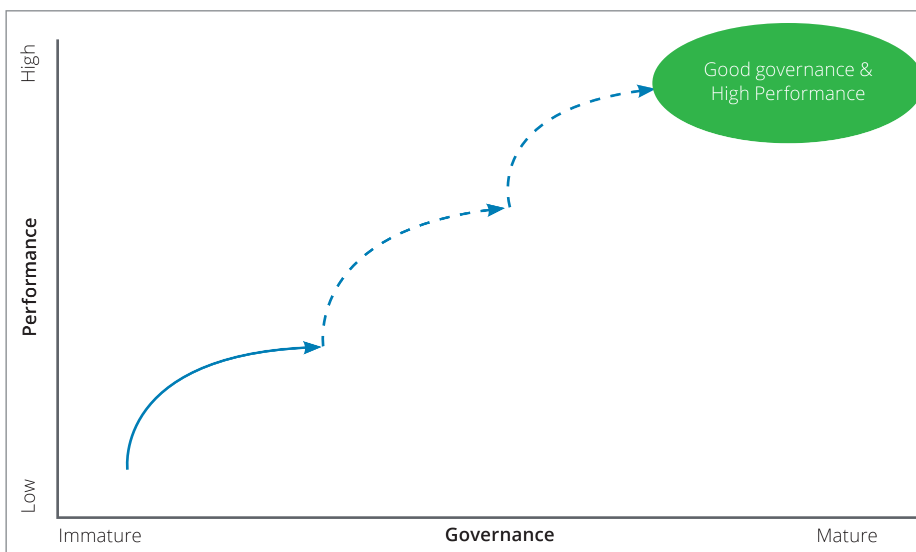
According to theory, 'good' governance refers to a combination of structures and mechanisms that align the interests of all parties involved (agency theory) and which ensures the voice of stakeholders is heard and information is distributed fairly (stakeholder theory). Its structures and mechanisms are needed to commit all parties to work together towards a common goal (stewardship theory). We investigated which governance variables have a scientifically proven correlation with corporate performance to help boards and directors decide on the right structures and mechanisms.

Dozens of empirical studies concluded a positive correlation between governance variables and corporate performance, measured in both financial metrics as well as non-financial metrics. Table 1 on the next page presents an overview of most distinct variables of governance in the research on the relation between governance and corporate performance.

What is 'good' governance?

In line with the agency theory, the board of directors assumes a monitoring function that aligns the interests of managers with the interest of the shareholders. Our research showed that various governance variables have a positive effect on the

Figure 1. Various governance variables have a scientifically proven correlation with performance



Variables	Impact on performance
Board independence	A higher number of independent board members improves the board's objectivity and ability to represent multiple points of view. But when the size of the board increases this might slow down the decision-making process
Board diversity	Demographic diversity has a positive impact on performance. However, when diversity is enforced by regulation (i.e. statutory diversity) there is no such effect.
Remuneration	Remuneration contributes to performance by aligning interests between shareholders and management. Stock options for the CEO may work well in good times, but have no effect when firm performance is stagnating.
CEO characteristics	Having a powerful CEO has a positive effect on performance but also leads to more risky decision-making
Oversight	An active oversight role of owners and boards has a positive effect on performance, especially in international joint ventures. A disadvantage however is that owners and boards tend to become less attentive during times of prosperity.
Ownership structure	Institutional ownership enhances the quality of strategic decisions made by the board, by actively engaging and adding an outside perspective.

likelihood that companies improve their financial and non-financial performance. The most effective variables of 'good' governance are board independence, demographic diversity, remuneration, CEO characteristics, and oversight and ownership structure.

Board independence
In the articles reviewed, 'board independence' is commonly measured as the percentage of independent non-executives on the board. The effectiveness of the board as a monitoring function is proven to be stronger when the number of independent members on the board is higher[x]. This will improve the board's objectivity and its ability to represent multiple points of view[xi].

However, an increase in independence can have a negative effect on environmental performance due to a lack of expertise and experience that insiders provide. This effect can be remediated by adding an environmental committee to the board providing expertise and focus on environmental problems[xii].

Board independence has a positive impact on a company's technical effiency, measured by its ability to transform input variables like labor, capital and technology into increased sale outputs[xiii]. In the public sector however, a higher number of independent board members is associated with lower administrative efficiency as decision-making slows when the size of the board increases[xiv].

Demographic diversity
The current discussion on regulating board gender diversity is based on convincing academic research about the benefits of board diversity. Several academic studies conclude that having women on the board has a positive effect on firm performance (return on assets, return on equity and Tobin's Q)[xv]. However, it is not the presence of women in itself, but the balance between men and women that positively affects performance[xvi]. In addition, executives should seek positive aspects of other management cultures and acknowledge interpersonal differences in order to increase board effectiveness. Our research showed that a high demographic diversity among board members has a positive effect on financial performance and the quality of strategic decision-making. However, statutory diversity driven by quotas has no effect on performance[xvii].

Research conducted on diversity within family firms shows that for these companies it is advisable to have a mix of family members and non-family members in the Top Management Team ("TMT") as this has a positive effect on financial performance[xviii]. This is strengthened in case the board has a strong control over the TMT, and when the CEO is a non-family member. We also found studies that showed such a relationship to be especially important during times in which the external environment of the company is changing, for instance in case of disruptive trends or events in the industry.

Remuneration

Remuneration can be used to align the interests of the shareholders and the management. Board compensation policy requiring directors and the CEO to own stock has a positive effect on a company's technical efficiency[xix]. Granting stock options to the CEO and management can provide useful incentives for long-term value creation. Research shows that CEO stock ownership and other performance related compensation also increase CEOs' behavior to seek external advice that results in better financial performance[xx]. A study in our research amongst 1.694 companies however evidenced that stock granted to CEOs during stagnant growth did not improve future performance[xxi].

Incentives also affect non-financial performance. The presence of environmental incentives as part of board compensation or CEO long term pay, show a positive effect on environmental regulatory performance[xxii]. For CEO long term pay this effect is even stronger in heavily polluting industries[xxiii].

CEO characteristics

The CEO plays a crucial role in setting the strategic direction and improving firm performance. Depending on their discretionary powers CEO's can have a positive influence on a company's financial performance[xxiv], also through the advice received via his or her individual external network[xxv]. CEO duality, where the position of the CEO and Chairman are combined, makes the CEO more powerful. Such a dual structure provides a single focal point, firm stability, and better communication between management and board[xxvi]. This structure occurs more in companies with a higher proportion of insiders on the board and where the CEO has greater formal power and agenda control. These powerful CEOs are more likely to realize positive changes to firm performance[xxvii]. However, it should be noted that a powerful CEO also makes more risky decisions[xxviii]. Moreover, CEO duality may lead to a weakened monitoring function of the board due to the CEO's control of the meeting agendas and location[xxix]. Hence, CEO duality may have both a positive and negative impact on financial performance[xxx].

Prior research concludes that companies with separate Chairman and CEO positions "consistently outperformed" companies with a single individual serving as Chairman and CEO[xxxi]. More recently, the International Corporate Governance Network consisting of over 200 of the leading institutional investors opposed to the CEO and Chairman being combined[xxxii].

Oversight

Several empirical studies demonstrate that boards tend to forget or neglect the importance of governance during times of prosperity. Owners and boards become less attentive and in some instances give too much freedom and independence to the CEO. If the CEO holds the position of Chairman during this time, the effect may even be stronger[xxxiii]. This overconfidence bias has a reversed effect on board effectiveness. As the monitoring activities of the owners and effectiveness of the board decrease, the CEO is increasingly more likely to assume power and increase personal wealth.

Board meeting frequency is a proxy for time spend on monitoring. Research however shows that as the number of board meetings goes up, the volatility of returns increases[xxxiv]. A specific study into International Joint Ventures shows that an increased level of involvement of the board has a positive effect on performance. This effect is the strongest in case the International Joint Venture has a broad functional scope and/or the parents' markets overlap[xxxv].

Ownership structure

The ICGN Global Stewardship Principles sets out ICGN's view of best practices in relation to investor stewardship obligations, policies and processes. Large institutional shareholders are believed to have both the incentives and power to monitor and influence decisions and activities of the board. Our research showed that institutional ownership significantly affects the relationship between board diversity and the quality of strategic decisions made by the board, as institutional investors actively engage with the board and add an outside perspective[xxxvi]. It should however be noted that institutional investors vary in their investment horizon and corresponding engagement. There are traditional institutional investors investing for the longer term holding either concentrated or diversified investment portfolios and there are short term active shareholders and hedge funds.

Main takeaways

The variables with a proven impact on performance may be obvious, but applying them in practice is not straight forward. For example, one does not just change the composition of the board in a day.

As governance elements strengthen and weaken each other, 'good' governance is developed when structures and mechanisms are balanced, and supportive to decision-making.

At the moments that crucial decisions need to be taken, directors are often faced with tough dilemmas. The right governance setup should help identifying, acknowledging and understanding these dilemmas and support the board in taking a well-balanced decision.

Building on academic insights, our research program continues to explore how governance affects performance by building further understanding of how governance affects the decision-making process in the boardroom, and consequent impact on performance.

Dilemmas

With many conflicting values at stake, boards are often faced with tough decisions. The right governance helps boards to effectively deal with dilemmas and make well-considered decisions.

Moments that matter

Many topics on the board's agenda are 'regulated', following standard procedures or are even being incorporated. The decisions that really matter are those that fundamentally affect the organization's performance. Identifying and adequately dealing with these decisions is key, especially because these decisions often imply making a choice between several desirable, or undesirable, options with no clear 'best' alternative.

Recognizing dilemmas

Dealing with dilemmas requires time for reflection, stakeholder dialogue, different perspectives and gradually reaching a point of self-confidence prior to making a decision. Yet, the full and formal agenda of the board often prevents required time to do so. Too often a crucial decision is not identified as a dilemma and dealt with like any issue that is business as usual.

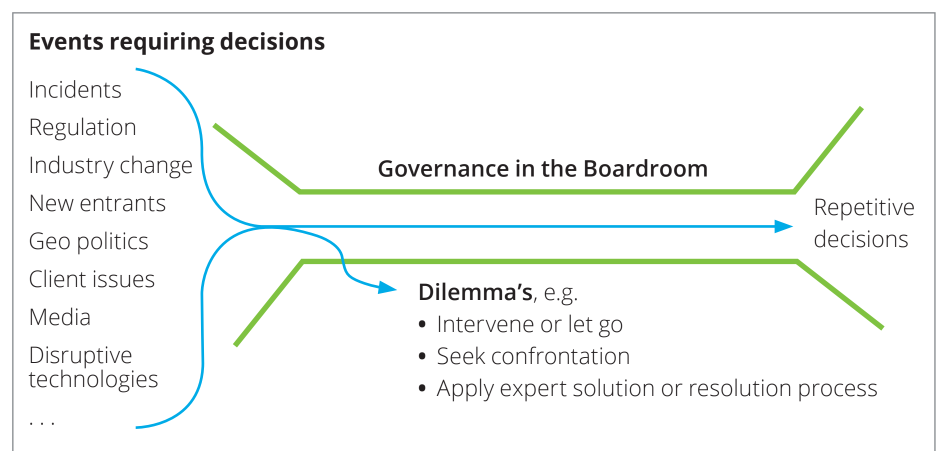
Recognizing dilemmas contributes to the quality of decision-making and has a positive impact on performance. However, research on decision-making shows that executives need to overcome many obstacles in dealing with dilemmas[xxxvii]. It requires the skill to make a judgement between several, sometimes competing values. The judgement has to be translated to an appropriate course of action and executives need the courage to engage in this behavior in an environment with many conflicting demands. One of the main obstacles in decision-making is that executives simply miss out on certain important values and only recognize them after the fact. That's when executives become aware that the best solutions are often in the past[xxxviii].

Governing decision-making

Dilemmas typically occur in times of transition, confrontation, incidents and reputational events, with probably the worst conditions for well-informed and balanced decision-making. Having the right governance in place is key to counterbalance these adverse conditions.

The setup of governance mechanisms in the boardroom has a big influence on the way how executives deal with dilemmas. Decision-making is not just an activity of individuals, it is a matter of creating the right conditions so decision makers can make balanced choices. Identifying the moments that matter, acknowledging to have dilemmas and understanding how the right governance will help is essential. Our research program continues to explore how good governance can help boards enhance their decision-making and improve performance based upon the academic lessons from the previous chapters.

Figure 2. Most decisions in the boardroom follow set procedures, but those decisions bringing tough dilemmas are the ones that really matter. We believe that how well the board is equipped to identify these moments and reconcile dilemmas is key to good performance.



Conclusion & Next steps

Our research concludes with six governance variables that may have a positive impact on performance. These insights provide a solid basis to engage in the dialogue on how they actually enhance decision-making and performance in practice.

Research results

Our research results support the hypothesis that good governance enhances corporate performance, as it produces six governance variables with an academically proven positive impact on performance. These identified 'good' governance variables are: board independence, board diversity, remuneration, characteristics of the CEO, oversight and ownership structure. Conclusive evidence is found that each of these variables can enhance corporate performance, but there is no one size fits all approach to applying them in practice.

The 'good' governance variables identified provide tools to structurally improve the decision-making process in the boardroom, and the firm's performance. The board can make the right decisions if circumstances so dictate. This requires collaboration, objective oversight and empowering alternate views.

How this works in practice is the subject of the next steps of our research program. We acknowledge that many of the critical decisions boards have to make represent tough dilemmas. To address this we will explore what these dilemmas usually are, and how our academic insights can contribute to finding the right interventions to identify and facilitate critical boardroom dilemmas.

Next steps

In conjunction with the introduction of the new Dutch Corporate Governance Code we will engage in a dialogue with boards and directors to further explore how good governance actually contributes to better performance.

Some themes included in the proposed revision of the Code overlap with our lessons learned, but will likely not provide practical implementation guidance. In addition, our research concludes that additional variables need to be considered in designing good governance.

In the next phase of the Deloitte - Nyenrode Research Program we will study what the critical dilemmas are that boards and directors face and apply the academic lessons gained during the first phase of the research program.

We kindly invite you to engage in this dialogue and contribute to the development of good governance practices that enhance corporate performance. It will help you implement better governance and performance.

Main takeaways

Building on the academic lessons from Deloitte and Nyenrode, we will continue to explore Boardroom dilemmas that impact governance If you want to stay involved you can participate in:

- Interviews with directors to validate the research findings and further explore the governance dilemmas that are encountered in practice.
- Ongoing dialogue, through events and roundtables on governance and performance and corresponding dilemmas in the Boardroom.

The next step in the research program will be:

- Developing a framework of types of boardroom dilemmas and corresponding interventions.

Methodology & Database

Within meta-analysis the lessons of individual studies are analyzed and consolidated. Combining the results of academic research will help us with a better understanding of governance as an overarching concept.

We reviewed the results of 59 selected studies including almost 120 empirically investigated relationships that examine the effect of a range of concepts of corporate governance on firm performance, both financial and non-financial. The lessons from the individual studies were analyzed and consolidated.

Selection criteria

The selection of the studies is based on a few criteria. These include the name of the journal and year of publication, keywords in the abstract, country of analysis and finally the direction of the relation studied.

Journals

To ensure the quality of the selected studies we only leveraged top-ranked journals. For this we used the ranking of the Chartered Association of Business Schools ("ABS") as it ranks the articles based on peer review, statistical information related to citation and editorial judgements from the detailed evaluation of hundreds of publications over a long period of time. The top 5 journals are:

- Strategic Management Journal
- Academy of Management Journal
- British Journal of Management
- Journal of Management Studies
- Journal of Business Ethics

Year of publication

We selected studies published between 2006 and 2016.

Keywords

As we study the influence of good governance on performance the keywords "Governance" AND "Performance" should be included in the abstract of the academic articles. These first three selection criteria resulted in 185 studies.

Accessibility and relevance

104 studies were accessible in the databases used. Based on a first reading of the abstracts another 45 studies were excluded. Leaving us with 59 studies, describing 120 relations.

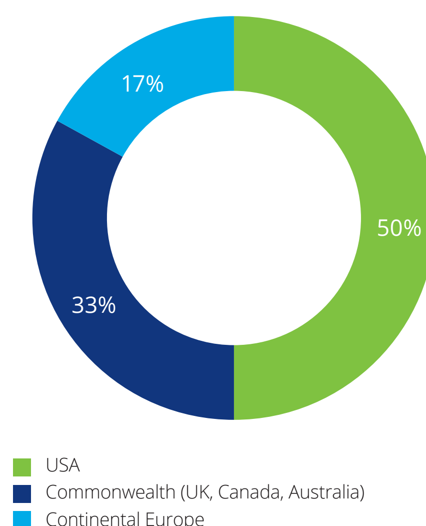
Country of analysis

Considering the comparability of the studies we have also excluded studies in which the country of analysis was other than the USA, Commonwealth countries or continental Europe. Leaving us with 46 studies, describing 106 relationships. As demonstrated in graph number 1and graph number 2 the U.S. was the country of analysis in half of the studies. The U.S was also the country of residence of most (42%) of the authors.

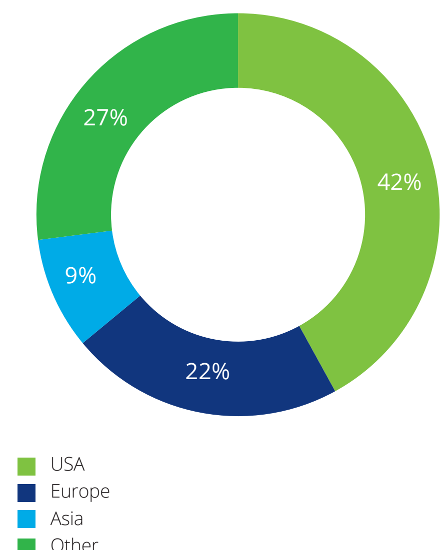
Direction of the relation

Finally we selected studies based on the direction of the relation: Only studies describing the influence of governance on performance were in scope. Out of the initial 185 studies, we now have 41 studies left, which describe 75 relationships

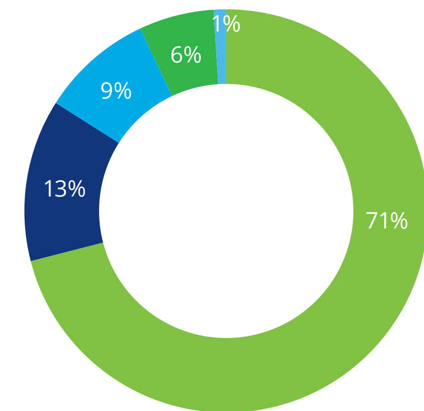
Graph 1: Country of analysis



Graph 2: Country of residence of the author

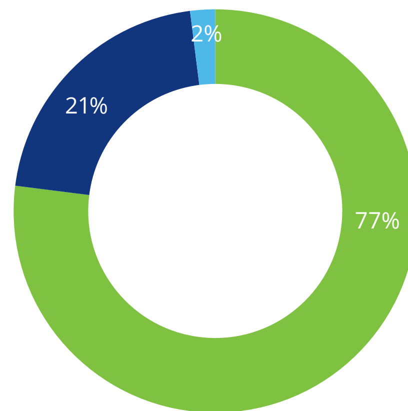


Industries



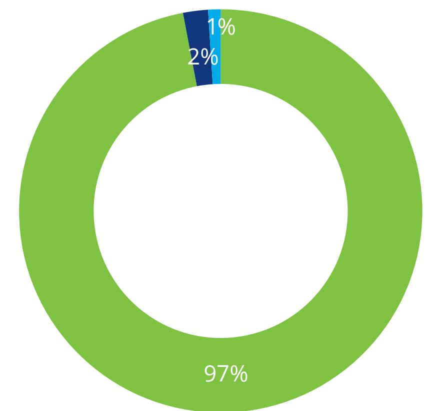
- Not specified
- Man
- PS
- TMT
- FSI

Listed/non-listed firms



- Listed
- Non-listed
- Family firm

Methods of research



- Quantitative
- Qualitative
- Review

Description of the database

For the in scope studies that were reviewed we have recorded the meta-data to provide insight in the context and quality of the academic articles studied.

Description of the unit of analysis

In most studies (71%) there was no specific industry focus, at least this was not referenced. In the other 29% of the studies there was a focus on Manufacturing ("Man"), Public Sector ("PS"), Telecom, Media and Technology ("TMT"") or the Financial Service Industry ("FSI").
The research was mostly about listed firms (77%), in some cases about non-listed firms (21%) and in only a few studies a specific kind of firm such as family owned firms was mentioned.

Methods of research

97% of the studies applied a quantitative research method. In a few studies a qualitative research method or review was used.

Year of publication

Most studies were published between 2008 and 2014, during the financial crisis.

Limitations of this study

This study provides an overview of the past learnings of corporate governance as the selected studies are set in the past. In reality most markets are constantly adapting to evolving corporate governance codes and the effect of such efforts will only be measurable in the future.

In addition, we could not control for potential selection bias of the researchers who chose the corporate governance variables for the selected studies.
Agency theory, stakeholder theory and stewardship theory are the main schools of thought describing the dynamics of corporate governance. These three theories provide fundamental explanations to many of the findings in this study. However, most of the selected studies are just based on the agency theory. As a result some parts of the corporate governance debate are not sufficiently addressed in academic research. This reminds us of some parts of corporate governance that are very relevant but are hard to measure and therefore not highlighted in this overview of academic research.

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