How do Boards Influence Organisational Performance?

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Abstract

As the effects of the global financial crisis upon organisational performance become increasingly evident and with some commentators implicating corporate governance in respect of corporate casualties, it is clear that a fresh approach is needed to understand the extent of influence that boards may have on their companies. This study proposes and confirms that a board's influence is facilitated through interactions with the executives in a relational space we have termed the "third team". To address this proposition, a survey of board and executive members of for-profit and not-for-profit organisations was conducted, followed by semi-structured interviews with a selection of participants. In exploring the interactions between the board and the executive, the study focused on the mix of characteristics in order to uncover the extent of this combined "team's" influence on organisational performance. The paper draws support for this model and the concept of shared leadership - an important element within the third team - from various authors (e.g. Drucker, 1989, 1990, Kozlowski & Bell, 2003, Pearce & Conger, 2003, Trecker, 1971, Vandewaerde, Voordeckers, Lambrechts, & Bammens, 2011). Shared leadership does not equate with equality; it does, however, highlight the conceptualisation of the combined board-executive as a team with a degree of shared leadership and responsibility for organisational performance.

Keywords: Board, Team, Performance

Introduction

For the past several decades, corporate governance research has focused predominantly on agency theory (Fama & Jensen, 1983, Jensen & Meckling, 1976) in attempting to explain the means by which a board adds value and influences an organisation's performance. From an agency perspective the board acts essentially as a watchdog for shareholders, overseeing the actions of the chief executive officer (CEO) and controlling management. Along with agency theory, researchers have also drawn upon stewardship theory (Davis, Schoorman, & Donaldson, 1997) and the resource dependency perspective (Pfeffer & Salancik, 1978) as a basis from which to identify a direct causal link between the board and organisational performance. These efforts to establish such a link have, for the most part, ignored the pivotal role that the executive (i.e. the CEO and executive team) plays in facilitating the board's influence on the organisation.

With regard to strategic leadership and its influence on the organisation, research has focused separately on the board and executive management, labelling the executive team variously as managerial elites, an upper echelon and a top management team (TMT) (Fama & Jensen, 1983, Sydney, Finkelstein & Hambrick, 1990, Hambrick, 2007, Hambrick & Mason, 1984). From this body of research two teams are conceptualised as providing leadership at the apex of an organisation: the board and the executive.

This paper proposes that there are in fact three top teams at the apex of control: the board, the executive team, and a third "team", and that it is through this combined third team that organisational performance is influenced, rather than directly by the board. In the context of this study the word "executive" refers to the CEO and those senior functional managers (e.g. chief financial officer, operations manager, marketing manager), who have regular formal or informal contact with the board and/or individual directors.

The need to better understand how a board influences organisational performance has become especially pressing as the magnitude and impact of corporate failures has continued to grow over the past two decades. In particular, greater clarity regarding the extent of this linkage, if it exists at all, is necessary since boards and directors are said to have been significantly implicated in various corporate failures that have occurred as a consequence of factors leading to the global financial crisis (e.g. Enron and Tyco). In other words, we cannot expect to address adequately the claimed shortcomings in current corporate governance practice without first understanding the impact of its central mechanism, the board of directors, on the performance of organisations. The aim of this study was to gain insight into this supposed linkage between the board and organisational performance, with regard to the means by which the board might have influence and the nature of such influence.

The paper is structured as follows: the theoretical justification for the third team concept is outlined and the research methodology is described. The research results are then presented and discussed with regard to the implications of the findings for board theory and practice.

Theoretical Background

Considerable empirical evidence exists for a direct influence by the executive on organisational performance (Barnard, 1938, Collins, 2001, Drucker, 1954, Schein, 1992, Selznick, 1957, Woodward, 1965). However, there is a lack of consistent evidence supporting such influence by boards of directors (Pettigrew, 1992). Moreover, the equivocal nature of findings in the body of research hoping to identify a direct link between boards and organisational performance has inspired suggestions that no such relationship may exist (Dalton, Daily, Ellstrand, & Johnson, 1998). The possibility that the impact of the board on organisational performance might be indirect has also been suggested (Pettigrew, 1992). To the best of our knowledge, however, no attempts have been made to establish the mechanism through which this indirect effect may occur.

In a separate research direction attention has been drawn to the importance of the relationship between the board and the executive team (Golensky, 1993). In establishing a model for diagnosing organisational behaviour Nadler and Tushman (1980) identified the level of interaction between individuals (directors and executive) as important in developing patterns of relationships both between and within other organisational groups (such as between the board and the executive). Furthermore, in examining the paradoxical governance dynamics of control and collaboration Sundaramurthy and Lewis (2003) suggested that the board's effectiveness may depend on how interpersonal relationships develop between the board and the executive. Various studies have positioned executive teams at the apex of power in organisations. These studies have defined executive teams as TMTs and have investigated their impact on organisational performance in relation to organisational power dynamics and control (e.g. Finkelstein & Hambrick, 1996, Mizruchi, 1983, Pfeffer, 1983). Other research wherein executive teams are conceptualised as upper echelons has built on the seminal work of Hambrick and Mason (1984) who examined top managers and their influence on the organisation. These studies have generally considered the board and executive as separate groups.

Recent work by Carpenter, Geletkanycz and Sanders (2004) noted that the most pivotal actors outside the immediate definition of TMTs or upper echelons were boards of directors. The importance of the board of directors in relation to organisational performance was highlighted earlier in the work of Finkelstein and Hambrick (1996) in their development of the “supra-TMT” concept in which the TMT and the board are aggregated in a single team. However, Carpenter, Geletkanycz and Sanders (2004) noted that the supra-TMT concept was challenged both theoretically and empirically for two principle reasons: from the agency perspective the board and executive have competing and possibly divergent goals and agendas (Fama, 1980); furthermore, there is evidence of inconsistency in results between studies using the TMT concept and those using the supra-TMT concept (Jensen & Zajac, 2004). When considering the question of who, at the apex of a firm, is more important with regard to the impact on organisational performance, Carpenter, Geletkanycz and Sanders (2004) argued for a broader, more flexible approach, suggesting that researchers should not focus exclusively on internal firm management.

In what relational space, then, might the board's influence occur? We define this relational space as an emotionally rich, inquiry-based environment in which both board and executive members can safely explore challenging issues (Bradbury, Lichtenstein, Carroll, Senge, & Powley, 2007) and work together towards achieving the organisation's objectives. Partnership is a term which has been associated with boards and executives in the way described by Bradbury et al (2007). Similarly, Trecker (1971) described boards and executives as partners in a common task. However, this description has also met with opposition (Golensky, 2003, Hoye & Cuskelly, 2003). Consistent with the agency perspective of the relationship between the board and the executive, Senor (1993, p. 19) argued against the notion of a partnership, contending that the term "partnership implies equality; this is hardly a relationship of equals!" Conversely, Drucker (1989, p. 91) argued that neither the board nor the CEO is "the boss", describing them rather as collaborators in a "team of equals" (Drucker, 1990, p. 10).

We posit that Drucker's (1990) use of the term "team" is appropriate when applied to the type of activity engaged in by the board and executive in the relational space within which the influence of the board occurs. The online Merriam-Webster Dictionary (2012) defines a team as a number of persons associated together in work or activity. The idea of a team does not imply either superiority or equality: it denotes a group of people who come together to achieve a common or agreed task. In working toward this end it is generally accepted that the team will have a leader; in the organisational context we contend that (strategic) team leadership is provided by the board (Vandewaerde, Voordeckers, Lambrechts & Bammens, 2011, Finkelstein & Hambrick, 2008).

The Merriam-Webster definition of a team as a group of people brought together to perform a particular task finds support in the management and organisational studies literature. Langton and Robbins (2007) and Kozlowski and Bell (2003) defined teams in this context as groups of people brought together for a period (e.g. for meetings) to work towards organisational goals. This definition is consistent with the way a board and executive also come together episodically for the purpose of organisational goal achievement. According to this view, we thus posit that the board and executive, when working collaboratively in this way can be regarded as a (combined) team. Conceptualised as such, however, the issue of power and leadership at the top of the organisation must be addressed. The question remains as to which of the two upper echelon teams (board or executive) is the more "upper"? Or, is it that neither upper echelon group (board or executive) is more "upper" than the other in the way they influence organisational performance?

In relation to upper echelon theory, Hambrick (2007, p334) stated that "If we want to understand why organisations do the things they do, or why they perform the way they do, we must consider the biases and dispositions of their most powerful actors – their top executives." In our view this statement does not suggest that the executive team is more powerful than the board but, rather, that the executive team has *more direct influence* over the *outcomes* achieved by the organisation. If this view of executive influence is accepted, it can also be argued that, as the most powerful actors *within* the organisation, the executives need input and guidance from key advisors (the board) so that they (the executives) can achieve the desired organisational outcomes. Indeed, the board's advisory, guidance and oversight role is consistent with the resource dependency and stewardship views, as well as the agency perspective, in the corporate governance literature. McIntyre, Murphy and Mitchell (2007) described the board as a team of individuals who play a role in developing and selecting creative ideas for the advancement of the firm. Carter and Lorsch (2004) differentiated between the board and the executive with regard to their respective leadership roles, whereby it is the board's role to establish the vision, mission, goals and strategies (in conjunction with the executive) and it is for the CEO (and the executive, under the CEO's leadership) to implement them.

Researchers and commentators such as Langton and Robbins (2007), Hambrick (2007), Drucker (1989, 1990), Golensky (1993) and McIntyre, Murphy & Mitchell (2007) indicate that if an organisation is to be high-performing (however this is defined) then co-operation and teamwork between the upper echelons, the two top teams – the executive and the board – are necessary. Co-operation and teamwork of this sort have been identified as a form of shared leadership by Pearce and Conger (2003, p. 1) who defined it as, “a dynamic, interactive influence process among individuals in groups for which the objective is to lead one another to the achievement of group and organisational goals or both”. This definition is consistent with Drucker’s (1990, p. 10) conception of the board and executive as a “team of equals” and also with Fletcher (1992, p. 283) in stating that “... previous research tended to understate the importance of the executive in making “the board work well”. The influence that this combined board-executive team effort has on organisational performance is highlighted by Vandewaerde, et al (2011) who noted that within the framework of team settings shared leadership has been shown to result in significant performance benefits.

Figure 1 depicts the combination of the two upper echelon teams – the executive and the board – described as existing within a co-operative, relational space – which we define as the third team (TT). We argue that it is this third team - a team of equals who work co-operatively together to achieve mutual outcomes for the benefit of the organisation - which is the true upper echelon in respect of its influence on organisational performance.

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Figure 1 about here

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The concept of the third team thus aligns with the view of the board–executive relationship as a team of equals (Drucker, 1990) and with the notion of shared leadership (Pearce & Conger, 2003, Vandewaerde, et al, 2011). Furthermore, the concept is consistent with Friedrich, Vessey, Schuelke, Ruark and Mumford's (2009) description of shared leadership in a team as a dynamic and fluid process of influence in which those with the relevant expertise lead discussion at any given time. Hambrick's (2007) view of organisational power and influence presented above can thus be re-stated in the following way: to understand why organisations do the things they do, or why they perform the way they do, we must consider the biases and dispositions of their most powerful actors - the most influential of which is the third team comprising the board and executive.

Research Objectives

In response to Pye and Pettigrew's (2005) call for multi-theoretical research into corporate governance, the research on which this paper draws sought to identify the nature of the relational space within which the board might engage with the executive to influence organisational performance. Based on the various streams of literature presented above which support the notion of the third team, we focused on the interactions that take place among the members of the two sets of players comprising this third team. To provide further conceptual support for the third team concept as occurring in a relational context within which board influence might occur, we drew upon four additional theoretical constructs: Leader-Member

Exchange (LMX) developed by Dansereau, Graen and Haga (1975), intellectual capital, as described by Nicholson and Kiel (2004), knowledge sourcing, described by Gray and Meister (2004), and team effectiveness as discussed by Payne, Benson and Finegold (2009). A mixed method approach was adopted for the research which incorporated thematic analysis of interview data with fuzzy set qualitative comparative analysis (fsQCA) of survey data.

Methodology

The corporate and not-for-profit (NFP) sectors in New Zealand and Australia provided the research population for the study, from which the results presented in this paper are taken and which represent a smaller part of the larger project. The corporate sample was drawn from the New Zealand and Australian stock exchanges' top 50 indices (NZX50 and ASX50). The NFP sample was chosen by selecting initially those organisations that were national representative bodies and were affiliated to an internationally recognised body. These two sector groups comprising publicly listed corporations and NFPs yielded a population exceeding 130 entities from which a total of 64 (43 corporate and 21 NFP) organisations were selected for the research sample. The corporate and not-for-profit sectors were of particular interest because while a substantial body of empirical research exists for both sectors in governance literature, each has been studied separately. To the best of our knowledge no studies have attempted to compare governance aspects across each sector, yet the assumption that the same models of governance apply to both corporate and not-for-profit organisations has been hotly debated. The following outlines the selection process for the corporate and NFP samples.

To qualify for selection corporations needed to be listed on either the New Zealand Stock Exchange (NZX) or the Australian Stock Exchange (ASX) and NFP organisations were required to be registered as an incorporated society; corporations must also have been listed prior to 31 December 1999, and NFPs must have been registered for more than 10 years. This initial population was filtered further using a range of financial measures appropriate to each sector (corporate and NFP).

Key performance indicators (KPIs) adopted for the corporate sector were: return on assets (ROA), earnings per share (EPS) and dividend yield (DY). These three KPIs were chosen for the following reasons: foremost was a requirement that the data for calculation purposes be readily obtainable through publicly available information. ROA indicates how well (or poorly) the company is generating cash from its asset investments, while the measures of EPS and DY are widely used by shareholders (who in agency terms are the principals), institutional investors, investment advisors and the general business community as key indicators of organisational performance (e.g. Brown L, M, & Caylor, 2004).

For the NFP sector, two measures from a study by Ritchie and Kolodinsky (2003): fiscal performance and an index of public support were used in this study, both of which were originally developed by Siciliano (1996, 1997). The larger study required the corporate and not-for-profit samples be separated into high-performing and poor-performing groups to allow comparison of board characteristics between groups. The purpose of the four sub-groups was to identify factors (causal recipes) associated with effective boards and high organisational performance for each sector.

Questionnaires were developed from the literature relating to each of the constructs discussed in the research objectives (above). These were sent to the chairperson, CEO (managing director) and executive members of the sample. The executive members were selected on the basis that they attended and reported to at least one board meeting per year and had other contact with the board either in social and/or formal settings, such as strategic planning sessions. Semi-structured interviews were also conducted with a selection of the survey participants. In total, 321 participants took part in the research; 98 participants were in the high-performing sub-group and 223 in the non-high-performing sub-group. An overall response rate of 39 per cent was achieved for the survey. A total of 23 hours of taped interviews with selected chairs, directors and executives of organisations within the high performing and poor performing (as defined in this research) samples were transcribed and analysed thematically. Participants (chairperson, director, CEO and executive) were randomly selected from the high-performing and poor performing organisations in each sector, based on their availability and willingness to participate.

The themes that emerged from within the survey drove the development of the interview questions. This method is supported by Greene, Caracelli and Graham (1989), who advocated the use of findings from a questionnaire to aid in the development of interview questions. The interview questions were semi–structured, with additional questions asked to probe for meaning or to explore new or emerging themes as the interviews progressed. Greene, et al. (1989) defined this mixed method approach as complementarity, where the research results obtained from one method are informed by another, thereby increasing validity.

Results

We have proposed that there are three top management teams in an organisation – the board, the executive team (TMT), and the third team (TT), through which organisational performance is influenced. This proposal is supported by the results of both the survey data (which we do not present in this paper) and the interviews (from which we quote below).

Variously the interviewees identified a high level of relationship building, partnership, collaboration and teamwork between the board and executive team in their organisations. Describing the board-executive relationship, one interviewee from the poor (non-high) performing sample described the relationship as a "...partnership; they [the board] have their respective roles within that partnership, but they get on as a sort of collective group very well." This quote highlights an important aspect of the how interviewees saw the relational space in which the executive and board functioned together as a team. Each team (board and executive) was understood as having their own respective roles and responsibilities yet when combined they also play a cooperative role with mutual responsibilities, such as collaborating in working towards a common organisational goal. The idea of the board and executive as a collective, cohesive group or team was further supported by another interviewee who said that “...you have the board, we have the executive team; you might well say that together we’re a team ...”

Support for the collaborative third team concept was also provided by the chair of a high performing organisation within the Australian corporate sample who commented: “...and just to the point about [whether] they are a third team [conveys a story about board reviews] my point in all is agreeing with you.” However, the description of the board and executive as a collaborative team does not imply that among a group or "team of equals" (Drucker, 1990) there is no leadership within this team: the board and executive recognise that the leader of this team is the board. The notion that the board provides the third team leadership was captured in the following statement by one respondent: “...there’s a relationship, but there is a distance. But it’s the way that those two things are just managed, so that they are neither too close, nor too far away. That’s really important ...” This leadership position of the board is logically consistent with the agency approach (and upon which much of corporate law is based) which places primary importance on the board's role in appointing the CEO and overseeing management. Among interviewees, however, it was accepted that as a practicality leadership is shared with the executive, being the agents of action within the organisation as argued by Carter and Lorsch (2004).

Further support for our proposed third team model was provided from the fsQCA analysis of survey data and, in particular, for the constructs of leader-member exchange, knowledge sourcing and social capital as key aspects of the relational characteristics that inform the nature of interactions that take place among the members of this third team. The notion of social capital is aligned with the internal and external ties and relationships within a small network (such as the third team) (Nicholson & Kiel, 2004). A key outcome of the acquisition of high social capital is the development of important working relationships within the third team. These results are not reported in this paper given their complexity and the restrictions on the length.

Analysis of the interviews showed that directors and executives were involved in a level of interaction, decision making and consensus building on issues, strategies and directional decisions that impacted, or were likely to affect, the organisation. The importance of the third team concept in facilitating these interactions was emphasised by the CEO of a high performing organisation who said that "...the CEO, I think these days, is not the person who necessarily makes the decisions, but is the person who facilitates the correct exchanges between management and board". Conversely, a director from a poor performing organisation stated that "...the CEO does not like the board talking to his executives. He makes sure his executives don't talk to the board... now the performance of that organisation reflects that... [The] organisation is growing only at the rate that the CEO has hours in the day, because he's got his hands on every point in the business." These contrasting outlooks highlight an important additional finding in relation to the third team model: for the interaction, decision making and consensus building on issues to occur, high performing organisations display higher levels of synergy, trust and confidence in each other within the third team space. The importance placed on these three elements is evidenced in the following comments by interviewees in high performing organisations:

> "...confidence and trust must come out of values and if you haven't got confidence and trust, you might as well all go home"; and "Yes I think if you haven't got trust

and respect, you're not going to have effectiveness... you're going to struggle to develop a strategy for a company...That lack of trust and respect will get in the way".

The characteristic of team synergy, described in the Oxford Dictionaries (2012) as the combined power of a group working together which is greater than the total power achieved by each working separately, is an outcome from our results that is facilitated by the attributes of trust and confidence. These two attributes are contained within characteristics found in the full range of causal recipes for board effectiveness in relation to high organisational performance developed from the fsQCA analysis in the larger study. Highlighting the influence on performance when there is a lack of synergy, trust and confidence, the CEO of a poor performing organisation said in relation to initiating open discussions with his board on matters of importance (e.g. strategy) that "...if you felt there was a level of cohesion within the group and trust, you'd just go bang, here it is, let's have the discussion."

Interviewees identified interactions between directors and executives as occurring in both formal and informal settings, rather than in formal meetings alone. It is during both the formal and informal interactions in third team settings that relationships are built and knowledge sourcing occurs. General comments from interviewees regarding knowledge sourcing are captured thus: "...from what I've seen, it happens when you are informally chatting about something and an idea will just come up and can be ... and something comes out of that and the particular knowledge of the director turns out to be helpful"; and "Well the answer to you is that a good executive brings it to the board... Why is he clever? Or she? They're clever because they're tapping the knowledge of the board: the diversity of opinion of the board. They're also getting the board into their way of thinking, as they put it." Importantly, the findings identified knowledge sourcing as a reciprocal activity between the directors and executive as captured in the following interviewee comments: "I can't speak for anyone else on the board, but I certainly have... taken a lot of the learning's that I've had on the ... board, to the international board”; and “... people say quite often [that] the board [directors] are taking away inputs from the management, from the same discussions... it is an exchange and that’s also part of the - I guess ambience - of the board meetings.”

The thematic analysis of the interview data together with the results of the survey data validate the third team model within which the constructs of intellectual capital, leader-member exchange, team (board) effectiveness and knowledge sourcing are found to facilitate the influence of the board on the executive who in turn influence organisational performance. Thus our proposition that the board influences organisational performance indirectly through its interaction with the executive, in a combined, collaborative interrelationship, is confirmed. In accepting as a starting point the idea expressed in the literature (Fletcher, 1992; Golensky, 1993) that the link between the board's contribution to the organisation's performance is an indirect relationship rather than a direct one, the findings from this study reveal some of the nature and extent of the board's influence which occurs in the relational space created around its interactions with the executive.

Conclusions

Previous empirical studies have generally focused on one of three dominant theoretical paradigms (agency theory, stewardship theory and resource dependency theory) as a basis for explaining how a board can influence organisational performance. The addition of the model, which we have labelled the third team to describe the hitherto unacknowledged ‘real’ team or centre of influence at the apex of an organisation, provides a new way to view the two separately conceptualised teams (the board and the executive) that have in the past been a focus in governance research. Our third team model contradicts the dominant (agency theory) view that these two separate teams: the board and the executive - are mutually exclusive and characterized by a subtly adversarial relationship arising from the principal-agent based monitoring and control role of the board over management.

Our third team model recognises that the board and executive meet episodically and combine efforts to produce a synergistic outcome that is beyond the capabilities of each team (i.e. board or executive), or team member (e.g. CEO), alone. The third team approach accords with the conceptualisation of a team defined by Kozlowski and Bell (2003), where a configuration of complementary efforts produces outcomes beyond the abilities of the individuals. Resource dependency theory posits that a key benefit from the board's contribution to the organisation is the access that the executive team has to the individual and collective resources (specific skills and experience, tacit and explicit knowledge, breadth of perspective, contacts and networks, etc.) of the board's directors. We argue that the third team model describes the environment or relational space within which this interaction occurs.

The model thus provides a context from which boards can gain a deeper understanding of the issues, assumptions and thinking of the executive in their decision-making. A greater understanding of the inner workings of the executive is consistent with the agency perspective of the board's control role in allowing the board to be better placed to guide and oversee executive actions. Such an understanding also aligns with the stewardship view with regard to the contribution each team makes to the organisation: where, in strategic decision making, the executive brings in-depth knowledge of the internal aspects of the entity and the board contributes to the decision process from a wider external perspective and breadth of experience. The study challenges the assumption that the CEO is the only employee/executive with whom the board should have direct contact (as implied in agency theory and is characteristic of poor performing organisations within our sample). Such an assumption fails to utilise the board's intellectual capital as a strategic resource (as argued from the resource dependency perspective) for the benefit of the organisation.

Within the study three defining characteristics of an effective third team were identified: synergy, trust and confidence. These characteristics help to facilitate the board's influence with the executive who, in turn, influence organisational performance. The study indicates that organisational performance is influenced by the type and extent of interaction between the board and the executive that occurs within the relational space created by the third team. This finding underscores the importance of the board-executive relationship in determining corporate governance effectiveness. More fine-grained research into this relational dynamic as it is played out in different organisational and cultural settings would provide deeper insight into the link between boards and organisational performance and further test our third team model.

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Figure 1: The third team