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A Review and Directions for Future Research

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Article abstract

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Board Functions and Firm Performance: A Review and Directions for Future Research

by

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This study provides a framework depicting the evolution of studies on the functions of boards of directors and their impact on firm performance. Four theories-legalistic, strategic choice, agency, and stewardship theory-are linked to describe the relationships in the evolution process underlying this phenomenon. From this review, directions for future research are identified.

Introduction

Juran and Louden (1966) noted that "it is an astonishing fact that the job (functions) of the board of directors is, in proportion to its intrinsic importance, one of the least studied in the entire spectrum of industrial activities". Nichols (1969) observed that in sociological circles, the study of directors has continued to be a "much neglected creature". Likewise, almost fifteen years later, Tricker (1994) remarked that "the work of company directors seldom features in the study of management". At the same time, Johnson et al (1996) noted that there is no convergence in the understanding of the roles of directors. They lamented on the uncertainties felt by directors concerning what their roles are.

Most of the studies on the roles of directors are largely descriptive in nature (Williamson, 1985). Studies that involve hypothesis testing are generally based on a single perspective, such as whether strategic planning is important to board. Consequently, statistical analyses relating board functions and company performance have been few.

Thus, over the years, research in this area continued its neglect in investigating the relationships between the functions of the board and firm performance. Examining the functions of the board is important as a unified understanding in this area allows board to be more effective. The purpose of this paper is to present a collation of past studies to present the evolution process of the study of board functions. We integrate these studies into a framework that links four theories commonly used to investigate this relationship, namely, (1) legalistic; (2) strategic choice; (3) agency and (4) stewardship. This framework presents a context of the functions of the boards of directors to the life cycle evolution of studies conducted in this area.

Legalistic Theory

Regarded as the earliest theory on corporate governance, the legalistic approach is grounded under the Companies' Act and common law. The theory suggests that boards contribute to the performance of their firms by carrying out their legally mandated responsibilities. Advocates of this approach posit that laws vest considerable powers in directors to enable them to fulfill their roles. Pennington (1986) reported that directors are required to undertake the legal functions in "good faith" and "due care" for the benefit of the company and shareholders.

Similarly under the Model Business Corporation Act, which has been either adopted or adapted by a number of states to serve as a legal governance framework, directors have a duty to manage and monitor the performance of their enterprise. Using a different terminology, Vance (1978, 1983) noted that directors' roles under the legalistic model are generally constitutional, that is, their roles are designed to fulfill the legal requirements of incorporation. Constitutional boards are akin to the setting up of a minimum board under a legal mandate.

Chaganti et al (1985) recorded that virtually every country's law decreed that the business affairs of a corporation be managed under the jurisdiction of the board. While the board may not necessarily need to have technical expertise related to the firm's services or products, it has legal power to ensure that the company reaches a certain level of acceptable firm performance. Thus, Zahra and Pearce, II (1989) noted that the two main legal functions performed by the board of directors are control and service. The control function encompasses the duties of (1) selecting and replacing the CEO; (2) monitoring the CEO's performance and (3) evaluating the company's performance to enhance effective management. This role ensures corporate growth by protecting shareholders' interest. Service role, on the other hand, involves the duties of (a) enhancing the company's reputation; (b) establishing contacts with the external environment and (b) giving counsel and advice to executives (Carpenter, 1988; Louden, 1982; Zahra, 1990).

However, control is the predominant function of the board. Chaganti et. al, (1985) argue that "a board may see its primary function as controlling the corporate performance, serving the corporation in controlling its external environment . ..". For effective control, Koontz (1967) proposed that directors should check on the company's performance "while the results are occurring and ideally, before they occur". One fundamental requirement for successful control is to fix deviations from plans before they happen. Gathering data on past events is not good enough as it may be too late to execute a change in plans as control that is dependent solely on past data is often nothing more than a "frustrating post-mortem".

Juran and Louden (1966) suggested that for directors to achieve "control before results", they should (1) set the course of the business so that the general directions are determined in advance and (2) they should preview up-coming plans developed by the CEO and his staff. The board can achieve some of these activities through (a) a thorough study of available leading indicators, (b) a broad-based judgement of what lies ahead, (c) a periodic re-evaluation of the company plans, and (d) developing alternative plans to circumvent unexpected events (Juran & Louden, 1966).

Directors have a legal obligation to ensure the continuity and performance of the company. Koontz (1967), for instance, noted that since a firm is designed as a legal entity separate from its owners to "furnish immortality", it is the duty of the board of directors to accept responsibility for the survival of the organization. Similarly, Henn (1974) and Kosnik (1987) argue that a board of directors is the formal representative of the company's stockholders. Therefore, their main task is to supervise the performance of the firm as well as the performance of management. In the final analysis, the "ultimate responsibility for corporate performance lies with the board" (Tricker, 1994).

However, empirical studies that have been conducted do not support the legalistic theory as directors do not always perform their legal responsibilities of control and service (Bacon 1973; Epstein, 1986; Juran & Louden, 1966; Koontz, 1967; Louden, 1982). These studies indicate, directors neither (1) evaluate the CEO's performance thoroughly; (2) enhance the company's reputation, nor (3) provide good advice to managers.

Although directors in theory hire executives to run the corporations, but, in practice, the reverse occurs (Epstein, 1986). Executives typically nominate directors. Thus, the control role of directors is no longer effective. Directors often fail to perform their legal mandate because they are "creatures of the CEO" (Patton & Baker, 1987) or simply "rubber stampers" (Zahra, 1990). Patton and Baker (1987) noted that very often, the chairman is also the CEO. He is therefore the chief protector of shareholders as well as chief manager, and therefore conflict of interests occur. When Patton and Baker (1987) interviewed a number of leading lawyers, bankers, accountants, and recently-retired chief executives about the practice of dual role of chairman-CEO, many felt that joint authority is likely to reduce the checks and balances the board is designed to provide for shareholders. Zahra added that as CEOs dominate boards, power is vested in these executives. As a result, they can select, reward or replace the directors.

Pearce II and Zahra (1991) also argue that since directors are principally selected and retained by the CEO, the board pays little attention to its control and service responsibilities. Board power is thus limited to the ceremonial approval of managerial choices, which falsely gives a form of legitimacy to the managers' actions. So, when companies do not perform well, boards are blamed for not checking on the managers' performance (Fleischer et al, 1988; Loevinger, 1986).

Moreover, directors are not equipped to handle changing organizational complexity. Boards typically have infrequent meetings, are given selective issues to discuss, and have little technical expertise in the business of the firm. Since CEOs are the most important person in the company, they typically do not want a capable board that can challenge their power and authority (Rosenstein, 1987). As a result, directors are often put in a difficult position to carry out their legal responsibilities.

Also, directors tend to be unobtrusive and they typically delegate the control authority to the CEO (Vance, 1978; 1983). For example, in the United States Steel Corporation, the board consists of a number of financial entrepreneurs who do not want to have an active role in the firm. As a result, all power has been relinquished to the CEO (Vance, 1983). The delegation of power to CEOs is most visible among the small, new, low-technology, and closely-held firms where the original founders are still working in the firm. In these firms, directors typically give the control function, which they are supposed to be responsible for, back to the CEO.

Epstein (1986) noted that in theory, directors hired executives to run the corporations. But, in practice, the reverse occurs: executives nominate themselves to directors who have no choice but to ratify their selection. Thus, the control role of directors disappears. Using court cases in the United States, Epstein found that the law has to intervene in companies when directors failed to perform their duties diligently. For example, in the case of Transunion Corporation, the directors were found to have acted in "unnecessary haste and sloppiness" in selling the company. They did not evaluate other bids, and thus the Delaware Chancery Court held that the directors were liable for damages to the shareholders. It is noted that the directors' exposure did not result from the decision in selling the company. It is rather that the directors were negligent in not following their legal responsibilities faithfully.

Vance (1983) advocated that for directors to play an important role, boards should become more collegial. As a result, directors should get peer status with the president and should be given "equal impact and equal vote" to serve as the decision-makers in the company.

The problem with the legalistic approach is that it tends to emphasize the indirect impact of the roles of the board on company performance. The functions of the directors, such as the selection of CEOs, the giving of advice, and the establishment of contacts, are needed in order to shape or aid managerial decision making. Even though directors may not be involved in day-to-day operations of companies, they should suggest, develop and implement strategies. Due to their formal position and involvement, they should make important strategic decisions for the growth, autonomy, and effectiveness of the firms (Zald, 1969). However, these functions are not the key emphasis in this legalistic approach. Instead, managers are directly involved in the functions typically expected of and are responsible for the performance of the firm.

Strategic Choice Theory

Founded under organizational theory, the strategic choice approach became widely used as the underlying theoretical foundation in investigating corporate governance research issues from the 1980s to the mid-1990s. This approach stresses that actions are undertaken by directors to help the firm adapt to its environment. The ability of the firm in adapting to its environment is argued as the main explanation of the organizational outcomes obtained by the firm. Therefore, the role of the directors progresses from the mere performance of legal tasks to those involved with strategy development (Kreiken, 1985). Strategy is the primary link between organization and environment (Miles & Snow, 1978). A list of functions undertaken by boards under the strategic agenda include (1) scanning the environment for information, (2) procuring assets, and (3) planning, implementing and evaluating strategic measures for divestments, acquisitions, R&D expenditures and capital expenditures.

Under this approach, boards actively participate in strategy formulation activities (Zahra, 1990). The reasons are that, firstly, as "boundary spanners", directors serve the role of linking the company to the environment as they have the necessary resources to collect useful information about competitiveness and industry changes. These are important for strategic actions. Secondly, as directors may be managers in other companies, they are in an advantageous position to provide information in strategic decision-making process. Thirdly, increasing shareholders' expectations has led to directors paying more attention to strategic activities. Fourthly, as the strategic decision formulation process is generally complicated, directors are urged to join in to provide inputs. Fifthly, as the result of the complex competitive environment, boards can offer CEOs guidance in strategic actions (see Zahra (1990) for a list of roles of directors in strategic process).

Zahra (1990), however, did not propose that boards replace CEOs in strategic process. As strategy formulation and implementation are an integral function of CEOs' responsibilities, Zahra suggested that CEOs and boards must understand the possible areas of conflict between them, and allow for mutual collaboration. These conflicts should be clearly stated and agreed upon. Directors should not do the work of CEOs and managers, and vice versa (Zahra, 1990; Kreiken, 1985). Strategy formulation and implementation is under the direct responsibility of top management and they are ultimately responsible for integrating the functional and divisional areas of the firm, and balancing the short-, medium-, and long-term planning and control cycles for the firm.

Hence, strategic management is still the function of the top management. Top management is responsible for "analyzing, developing, and changing the firm's external and internal processes and structures to make it effective and efficient" under changing environmental constraints. The role of the directors involves (1) making strategy a regular topic on agenda, (2) knowing the origins of the plans, (3) taking a broad analysis of environmental factors, (4) considering strategic alternatives, and (5) checking on progress and adaptation of strategic plans and actions (Kreiken, 1985).

It is assumed under the purview of strategic choice theory that companies with better strategies will achieve higher levels of financial performance (Hambrick & Mason, 1984). With board involvement, CEOs and managers will be more effective because the board will check on their assumptions made by managers when advancing strategic decisions (Andrews, 1986). Also, outside directors add objectivity to the strategic process, and hence enhance the firm's performance (Baysinger & Hoskisson, 1990).

Empirical studies found general support for the strategic choice theory. Based on a survey of CEOs, Tashakori and Boulton (1983) found that broad involvement in all phases of strategic planning process has risen significantly. In another study, Lorsch and MacIver

(1989) in conducting interviews found predominance of strategic decision-making activities in board functions. In another study that was based on five case studies involving U.S. companies, Mead Corporation, Rohm and Haas, Dayton-Hudson Corp., Hercules Inc and Gould Inc., Rosenstein (1987) noted that directors are actively involved in strategic planning. For example, in Dayton-Hudson, the board spends considerable time in strategic decision-making activities, mainly in connection with the capital expenditure process, which is typically long-term and broad in nature. Rosenstein further substantiated the importance of strategic activities from two directors in the 1984 Korn/Ferry Annual Board of Directors Survey and the 1983 Spencer Stuart and Associates Survey. In both surveys, strategic planning was ranked as the second most important issue facing directors. In the first survey, financial results was the most significant while in the second survey, it was succession planning.

However, Alexander et al (1993) proposed that the size of the board can be used to predict the level of active involvement of directors in strategic decision-making activities. In hospitals with large boards, Alexander et al found that the CEOs use their power to protect themselves. Consequently, the strategic process in such companies is stable with no active participation of board members. On the other hand, in smaller-focused boards, CEOs were replaced frequently. Directors were more preoccupied with strategy in these hospitals. Using the same argument, Goodstein et al (1994) also found that smaller boards succeeded more at promoting strategic changes than those of larger boards from a study of 334 hospitals.

As to the impact of strategic decision-making activities by board members on firm performance, Lynch (1979) in analyzing two organizations over two and a half years, found increased revenue turnover and profits when board members increased their involvement in strategic activities. In a study involving 139 companies from Fortune 500 firms, Pearce II and Zahra (1991) found that there is a positive relationship between participative boards and earnings per share of firms. They argued that in a "participative board", both directors and CEOs have equal power, and in working together, can channel their energies and abilities to develop explicit strategies that enhance the firm's performance. Similarly, in a study involving 42 companies from the biotechnology, hospital, textile and other diversified activities industries from Fortune 500 firms, Judge and Zeithaml (1992) in using the LISREL statistical method, found a positive relationship between board involvement in the strategic decision process and the average return on assets of companies.

Even though some studies indicate that boards are increasingly more involved in strategic decision-making activities, strategy determination is still not the most important objective of the board. In an intensive study involving seven-five in-depth interviews and several hundreds of shorter discussions with company executives, Mace (1986) found that most boards in medium and large companies still do not decide on the strategies of the firm. And the reason for this is simple it is because the CEOs do not want it to be so.

While theoretically and empirically stronger than the legalistic approach, the strategic choice model has its weaknesses. Firstly, the term "strategy" is used loosely in the literature review in corporate governance. The dynamics and processes involved in the strategic decision-making activities are not studied in detail. As noted by Zahra (1990), the strategic process ranges from articulation of the mission statement to implementation, control and review and there are 26 potential roles for directors in this process (see Zahra (1990) for more details).

Secondly, the literature review appears to suggest that forming an effective board is relatively straightforward. Get all the directors to be involved in strategy and a company will perform well. This is too simplistic. There are many other mitigating factors that impact on firm performance, which is the ultimate objective of the study of strategic management.

Thirdly, while a number of performance indicators are analyzed in the literature review, they are financial in nature. The study could be more complete with the inclusion of some non-financial indicators. As argued by Hilmer and Tricker (1990), a danger in corporate governance is the over-emphasis on financial measures. It is easy to pay attention to a single measure, such as short-term profits and lose sight of the other, longer-terms aspects. There is therefore a need to assess performance in other areas such as (1) market development, (2) product development, (3) research, (4) labour relations, (5) productivity, and (6) social responsibility and standing. Balancing the financial and non-financial performance indicators is vital for the success of any firm.

Agency Theory

Rooted in finance and economics, agency theory is the most well-applied and longest established theory that has been used to explain the contributions made by boards to firm performance (Berle & Means, 1932; Davis et al, 1997). In spite of this popularity, the specific functions of directors in relation to governance activities were hardly expounded on.

In explaining agency theory, Berle and Means (1932) noted a divergence of interests between owners and managers of any firm. According to them, an owner is in a position to both manage an enterprise, or delegate the management of the business in order to maximize profits or benefits from the business. The manager, on the other hand, only operates an enterprise, presumably for the well being of the owners. Owners have three interests. The first is that the company should be able to earn the maximum profit under an acceptable degree of risk, the second is that they want as large a proportion of profits should be distributed to them as possible, and third, the company's stock should remain freely marketable at a fair price. A manager, in contrast, has only one major aim, that is, to run the company for his "personal profits".

Similarly, Davis et al, (1997) noted that both agents and principals within the agency framework try to attain as much utility with the least possible effort/risk. Williamson (1975) termed such a phenomenon as "opportunism" whereby people act with self-interest and guile in pursuing their own goals. The agency problem is also characterized by asymmetric information, that is, the principal has a more restricted information set than that of the agent. For example, shareholders cannot perfectly monitor the managers' effort, which again creates a potential for agents to pursue their own goals.

To reduce agency costs, firms need to align the interests of managers with the stockholders. Suggested measures include (1) the separation of CEO and chairman because the CEO cannot both represent the shareholders and management due to conflict of interest (Rechner & Dalton, 1991); (2) equity ownership by firm's managers to tie the managers compensation to the level of the firm's performance (Jensen & Meckling, 1976); (3) strengthening the governance structure of organizations whereby board of directors keep potentially self-serving managers in check by performing audits and performance evaluations (Fama & Jensen, 1983a); (4) managerial labour market in which a poor performing manager limits his/her career opportunities in the future (Fama, 1980); (5) market for corporate control in which a poor performing firm risks being acquired by another and the consequence of the takeover is the hiring of all managers in the previous administration (Grossman & Hart, 1980) and (6) inclusion of at least some outside directors to monitor the performance of the CEO and other managers (e.g. Baysinger & Hoskisson, 1990).

Directors can therefore keep potentially self-serving managers in check by performing various monitoring mechanisms and performance evaluations. The board's function is to act as an ex post monitor of the company's performance, in particular, to decide whether the CEO, who is responsible for the firm's performance, should continue in office or be replaced (Scott,1983).

For an effective monitoring to occur, directors need to communicate shareholders' objectives and interests to managers and monitor them to keep agency costs in check. Outside (non-management) board leadership and membership are desirable to ensure that proper management of management occurs. If monitoring fails, Walsh and Steward (1990) suggested that the more expensive external measures, such as acquisitions, divestitures, and ownership amendments, would arise. As external controls may be detrimental to the principals, monitoring is generally preferred.

It is important to note that agency theory is different from the legal approach. The legalistic theory views directors' power coming from state law while agency theory suggests that directors' power arises from shareholders. Moreover, while control is the most dominant function of directors under the legal theory, monitoring is its counterpart under the agency theory. Budnitz (1990) sees the legal theory as less specific in identifying directors' duty to shareholders than is the agency theory.

As for the relationship between directors' functions and company performance, agency theory advocates perceive the board's effectiveness in monitoring management to be crucial (Stroh et al, 1996). The monitoring efforts will help to (1) reduce agency costs and (2) ensure compliance of managers to focus on established procedures and goals. Directors have a role to oversee and ratify management's performance (Bacon & Brown, 1975). Monitoring practices that align principals' and agents' interests and discourage or prevent agents from pursuing self-serving objectives should be positively associated with firm performance (Fama, 1980). The consequent result is the maximization of company profitability and shareholders' wealth.

Studies have generally shown the existence of agency problem. As early as 1932, Berle and Means (1932) pointed out that conflicting interests between owners and managers have led to the extreme result of wrecking a company for personal profits. For instance, between 1900 and 1915, a number of railroads were brought into receivership, presumably done mainly for the benefit of managers, while heavy losses were suffered by the security holders (owners).

In a recent study, Tosi and Gomez-Mejia (1994) studied the monitoring of CEO compensation and its relationship to performance index (comprising profitability, stock price, earnings per share and return on investment) of 418 U.S. corporations. They concluded that the monitoring of CEO compensation is positively related to firm performance.

Agrawal and Knoeber (1996) conducted an extensive study on the seven monitoring mechanisms and its relationship with firm performance on 400 large U.S. firms. These mechanisms are: (1) managerial shareholdings, (2) institutional shareholdings, (3) large shareholdings by individual shareholders, (4) use of outside directors, (5) debt policy, (6) managerial labour market and (7) threat of displacement. They found that greater managerial shareholdings was positively related to firm performance, while outside representation of boards, debt financing and threat of displacement were negatively affected. Agrawal and Knoeber proposed two possible reasons for the significant negative relationship between outsider directors and firm performance. One reason is that outside directors are added to boards only when firms are performing poorly (Hermalin & Weisbach, 1988). Another possible rationale is that outsiders are sometimes added to boards for political reasons and do not have the ability to directly reduce the firm's poor performance.

The problem with the agency theory is that it appears to suggest that managers are "bad". The theory is grounded on the self-interest of CEOs and other managers. In reality it is possible that as managers contribute their scarce human capital to the organization, they can be as equally, if not more, concerned with the success of the company as the owners. Managers will therefore reduce agency costs and poor firm performance on their own accord.

This theory assumes that people are individualistic and self-serving. However, Jensen and Meckling (1994) criticized this model of man as being a simplification for mathematical modelling and an unrealistic description of human behaviour. Doucouliagos (1994) also argued that labelling all motivation as self-serving does not explain the complexity of human action. Frank (1994) suggested that this model of man does not suit the demands of a social existence. Man takes care of both his personal and social needs at the same time. Self-interest can be sacrificed for the sake of organization. In broad-brushing reality in exchange for simplicity and elegance in their models, agency theory assumptions may limit its generalisability (Hirsch et al, 1987).

Stewardship Theory

Agency theory provides a useful way of explaining relationships where the parties' interests are at odds and can be brought more into alignment through proper monitoring and a well-planned compensation system. However, stewardship theory can be used to explain other types of human behaviour.

Regarded as the latest theory that is added to corporate governance research, the stewardship approach examines situations in which CEOs and other executives as managers are motivated to act in the best interests of their principals (Donaldson & Davis, 1989; 1991; Davis, Schoorman & Donaldson, 1997). Proponents of this theory argued that the model is based on the perspective that a manager whose behaviour is pro-organizational and collectivistic has higher utility than individualistic, self-serving behaviours. Thus, even where the interests of the manager and the principal are not aligned, the manager places higher value on co-operation than defection. Since the manager perceives greater utility in co-operative behaviour and behaves accordingly, his or her behaviour can be considered rational. Stewardship theory is often contrasted with agency theory as the latter presumes that managers are seeking to maximize personal benefits (Fox & Hamilton, 1994).

Stewardship theorists argue that there is an important role for directors ((Donaldson & Davis, 1989, 1991, 1994; Fox & Hamilton, 1994). Directors should empower governance structures and mechanisms to maximize the benefits of a steward. For CEOs who are stewards, their pro-organizational actions are best facilitated when the corporate governance structures give them high authority and discretion (Donaldson & Davis, 1991). Structurally, this situation is attained more readily if the CEO is also chair of the board of directors. The CEO-chair who is unambiguously responsible for the fate of the corporation will have the power to determine strategy without fear of countermand by an outside chair of the board. Thus, stewardship theorists argued that directors should play a greater role in facilitating and empowering managers instead of monitoring and control.

With regard to the linkage between directors' role and firm performance under the stewardship theory, it is quite subtle. The reason is that according to stewardship theory, the behaviour of the manager is collective who seeks to attain the objectives of the organization (e.g., sales growth or profitability) himself. This behaviour in turn will benefit principals such as outside owners (through positive effects of profits on dividends and share prices) and also principals who are managerial superordinates, because their objectives are furthered by the manager. Stewarsdhip theory assumes a strong relationship between the success of the organization and the principal's satisfaction. A manager protects and maximizes shareholders' wealth through firm performance, because, by doing so, the manager's utility functions are maximized. Thus, the directors will play a more indirect function; they empower the managers, who will directly be responsible for the performance of the company. Empirical studies are however lacking to the theory's recency.

The difference between agency theory and stewardship theory rests on the relationship between corporate managers and stakeholders. Whether the model is "agency" or "stewardship" is insignificant if a stakeholder is disadvantaged due to an action by another stakeholder. The stewardship theory is morally appealing as it potentially includes the interests of all relevant stakeholders. Minus the moral attractiveness, the theory will be just like a more sophisticated benefit-cost analysis.

Areas of Future Research

The theoretical framework of the functions of directors that is explained under four existing theories is summarized in Table 1. Under the legalistic theory, it is assumed that directors have a legal mandate to ensure the performance of company through two main roles control and service. Under the theory of strategic choice, directors secure valuable resources and enhance the performance of the company through strategic decision-making activities. Under agency theory arguments, due to the separation of ownership and management, directors need to protect the interests of shareholders by monitoring the activities of the managers. The stewardship approach argues that managers are willing to perform their best for the company and so there is minimal need to monitor the managers. Instead, directors should try their best to "empower" the managers for the greatest potential.

In terms of performance indicators, we found that financial measures are dominant, possibly due to the objectivity and preciseness of such criteria. Empirical studies lend support to the strategic choice and agency theories. On the other hand, the legalistic perspective is not supported. Directors do not always perform their legal duties. As the stewardship theory is relatively "new" vis-ˆ-vis the others, empirical evidence is currently lacking. Nonetheless, these theories have their own limitations. External environment and specific yardstick for performance are not considered under the legalistic approach. For the strategic choice theory, the definition of strategy is found to be too wide and there is lack of empirical evidence. The treatment of managers as opportunistic and self-interested appears to be too harsh under the agency theory. In contrast, the stewardship theory seems too idealistic as managers are regarded to be motivated to perform in the best interests for their companies.

While all four theories may still be investigated at any point in time, the literature review depicts an evolution of the research in this area. The legalistic approach was popular from 1960s to 1970s while the strategic choice approach appeared in earnest from 1980s to mid 1990s. Then come the agency theory and finally the stewardship argument. The legalistic perspective gained prominence in 1970s as a result of the growing interest in "reforming" boards (Mueller, 1979) in view of corporate scandals leading to widespread perception of boards as ineffective (Bacon, 1979; Herman, 1981). The proponents argued for a change in laws on (1) how directors should be selected, (2) how to protect the interest of shareholders, and (3) how to promote corporate governance with the addition of outside directors, female and minority group on the board (Patton & Baker, 1987). Next, the strategic choice theory gained considerable attention in 1980s as a probable consequence of the importance of the external environment (Zahra, 1990).

Table 1: Theories on Relationship between Directors' functions and Corporate Performance

	Theories			
Dimension	Legalistic	Strategic Choice	Agency	Stewardship
Foundation Gist of Theory	Corporate law Legal obligation to ensure performance of company	Organizational theory Using strategy to enhance company performance	Economics & Finance Monitoring COO and managers to ensure their efficiency	Psycology & Sociology Empowering CEO and managers to perform their best
Dominant Function of Directors	<u>Control:</u> Choosing and monitoring CEO Protecting shareholders' interest	<u>Strategic:</u> Scanning environment and securing resources Strategic decisions	<u>Monitoring:</u> Choosing and rewarding CEO Evaluating CEO and company performance	<u>Empowering:</u> Enabling goverance structures for maximum potential of CEO and managers
Performance Criteria	No specific measure	Sales, profit, return on assets, earnings per share	Profit, return on investment, stock price, earnings per share	Return on assets, return on equity, earnings per share
Empirical evidence	Generaly not supported, e.g. boards are regarded as creatures of CEOs and rubber stampers	Generally supported, e.g. boards are found to be involved in strategic planning and there is positive relationship between strategic planning and firm performance	Generally supported, e.g. monitoring of CEO compensation led to better firm performance	No conclusion due to theory's recency
Limitation	No consideration of external environment	Strategy is defined too widely Lack of empirical	Theory is generally regarded as too "harsh" about	Theory is generally as too "idealistic" about the

	No specific yardstick	studies	the behavior of managers	behavior of managers

As management is involved in day-to-day running of the firm, there is a need for another group to set long-term plans for the companies. This function therefore falls into the hands of directors who are often regarded as the "boundary spanners" between the firm and the environment (Rosenstein, 1987). The agency theory becomes predominant in 1990s as a result of the vast number of corporate takeovers during this period. For example, Clarke and Monkhouse (1997) noted that the extent of merger and acquisitions activity during the 1990s has alienated executive management from effective shareholder control. To protect their own interests, management has advocated the use of anti-takeover devices like "poison pills", leading sometimes to an entrenched, inefficient and conceited management who lacked accountability (Hutton, 1995). There are increasing calls for directors to monitor the performance of the managers. Finally, the stewardship theory is put forth as a probable alternative to the agency theory. Managers should not be regarded only as opportunistic and individualistic; they can be pro-organizational and motivated to do good for the company (Davis, et al., 1997).

Which theory is the predominant one could also be the result of the growth in company size and maturity. As proposed by Juran and Louden as early as 1966, the main reason for the existence of directors keeps changing as a company evolves. At first, the primary factor is "because the law says so". Next may be "to help the CEO" and later the principal reason is one of trusteeship. Juran and Louden added that as a result of these changes, the functions of the directors vary accordingly.

Applying the theories, it can be noted that they are dynamic too. Initially, when the firm is in its infancy, the legalistic theory ("because the law says so") stands out. Directors have to control everything to ensure compliance at this stage to ensure the firm's continuity and survival.

Figure 1: Changing Functions of Board of Directors
Growth in Company size and maturity

Small & owner-managed companies		Large & professionally-managed companies
Solely Because The Law Says You Must	To Increase the effectiveness of CEO	As trustees for the owners
Legalistic theory	Strategic choice theory	Agency and stewardship theory

As the firm evolves, the dominant theory becomes that of strategic choice, scanning the environment for resources and undertaking strategic management "to help the CEO". Following this, the directors have to monitor agents to ensure that CEOs and managers are acting in the best interest of the firm. Finally, directors delegate most duties to the CEO and senior managers because these managers have proven that they can be trusted to act in the best interest of the firm.

Despite the apparent popularity of theories over time, we prefer to take the view that it can be expected that all the board functions listed under each of the theories be performed simultaneously. However, one theory and one main function may be more predominant than the others. Johnson et al (1996) argue that there is no convergence of a specified role set for directors because of the multiple functions undertaken by the directors. Researchers such as Mintzberg (1985) and Drieghe and Baysinger (1986) have suggested more research to be conducted to combine the different functions of directors within an organization. Similarly, Eisenhardt (1989) in her review of agency theory, noted that the theory presents a partial view of the world that, although it is valid, also ignores a good bit of the complexity of organizations. She recommends using multiple theories in future studies so that greater complexity can be captured. Using multiple-theory approach to a study should not be regarded as diverse. Instead, it could be a focused analysis as the research problem on the relationship between different directors' roles and company performance can be explained in details. At the same time, the various limitations of the four theories, such as the heavy emphasis on quantitative financial indicators and lack of empirical studies on strategic and stewardship theories, can be tackled at the same time.

In the review of corporate governance, studies on the linkage between board functions and company performance is generally lacking. The available studies typically involve case studies and frequency counts from surveys which is not statistically rigorous. Secondly, the number of variables representing firm performance are few. They should include quality of output; customer satisfaction/retention; employee turnover; employee training; R&D investments; productivity; new product development; market growth/success and environmental competitiveness and other non-financial measures such as morale and commitment (Zald, 1967; Brancato, 1995). In the same manner, Venkatraman and Ramanujam (1986) suggested incorporation of other measures besides accounting ratios because different performance measures provide different perspectives on the impact of the board.

On the other hand, the literature between other aspects of board attributes, such as board composition, characteristics, structure and process, and firm performance are much richer and more thorough (refer to Tricker, 1994 for a review). A possible reason is that it is much easier to quantify these aspects (like number of directors, number of CEOs who are chairmen at the same time, number of insider versus outsider directors) than board functions. Pfeffer (1972) echoed that while there are books on what the duties of directors are and how they should function, such research has been "non-quantitative and prescriptive".

With the above in mind, we conclude by proposing two areas of potential research. The first is to study the evolutionary process of the roles of directors, incorporating the different functions over the life-cycle of a firm. Within the study, the functions of directors in the strategic process should be examined in more details. At the same time, more performance measures, both quantitative and non-quantitative, should be used. This will serve to narrow a research gap by improving the limited number of studies on board functions and its relationship with company performance.

A second potential research area is to compare, contrast and analyze the agency and stewardship theories in more detail. This study will be both challenging and interesting, as the two theories are generally competitive in nature. From the review, agency and stewardship theories are at both ends of the spectrum. To give higher weight to the study, besides directors' roles, other corporate governance variables like CEO-chairman duality, insider-outsider directorship and audit committee influence can be examined. An added value arising from this study is filling the lack of empirical evidence on the stewardship theory, which is unavoidable due to the theory's currency.

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