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Corporate Governance and Board Diversity

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REVIEW OF LITERATURE & EMPIRICAL RESEARCH: IS BOARD DIVERSITY IMPORTANT FOR CORPORATE GOVERNANCE AND FIRM VALUE?*

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ABSTRACT

This paper builds on the earlier MAS staff paper published by the same author in March 2004 by updating the recent empirical research on corporate governance and examines at length the issue of board diversity in section 7 to 10.

Board diversity refers to differences or variation in the age, gender, ethnicity, culture, religion, constituency representation, professional background, knowledge, technical skills and expertise, commercial and industry experience, career and life experience of the members of corporate boards of directors.

The recent wave of high profile corporate scandals in the U.S. and Europe has placed the issue of board effectiveness under intense scrutiny by various stakeholders. Institutional investors and shareholder activists have also pressured firms to appoint directors with different backgrounds and expertise under the assumption that greater diversity of the boards should improve board functioning.

But, does greater board diversity improve board functioning? If so, in what way does the board diversity improve board functioning? How is board diversity related to a firm's profile, social norms and external environment facing the firms? This paper attempts to shed some light on these questions by looking at the relevant theories on boards of directors, namely the agency and resource dependence perspectives of a board's function and also relevant empirical studies to date. This paper also helps summarize recent increased research and empirical study on board functioning and attributes of board members including board diversity in search of a more parsimonious corporate governance model to better explain the relationship between board composition and firm performance

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1.0 INTRODUCTION

1.1 Corporate governance is about putting in place the structure, processes and mechanisms by which business and affairs of the company or firm are directed and managed, in order to enhance long term shareholder value through accountability of managers and enhancing firm performance. In other words, through such structure, processes and mechanisms, the well-known agency problem – the separation of ownership (by shareholders) and control (by managers) which gives rise to conflict of interests within a firm may be addressed such that the interest of the managers are more aligned with that of shareholders.

1.2 This paper is organized as follows: Section 2 to 6 explain the origin, the what, the why and the various internal and external mechanisms of corporate governance; Section 7 to 10 then focus specifically on board diversity, the various models explaining how board diversity might impact the board functions of monitoring and provision of resources, which in turn affect firm performance; Section 11 concludes.

2.0 CONCEPT OF FIRM

2.1 Traditional economists view a firm as a production function (Coase 1937). This view treats capital and managerial effort as merely factors of production, without reference to property rights. Thus, managers allocate resources as they see fit without proper accountability for their decisions. This classical production function does not include the influence of public policy, family dynamics, and network exigencies common in some emerging economies such as Asian corporations. Simply put, this view says little about the contractual relationship between stakeholders, boards, and managers.

2.2 Neo-classical economists see a firm as a nexus of contracts (Alchian & Demsetz 1972; Jensen & Meckling 1976; Fama 1980). Fama (1980) views firm as an "*efficient form of economic organization*" where the various resource owners are pooled together in order to produce goods or services demanded by customers at the lowest cost. Through the firm, the various resource owners increase productivity through cooperative specialization. The relationship between the owner of the firm (i.e. residual claimant) and team members such as employees and suppliers is simply a "*quid pro quo*" contract. They stress that property rights are shaping economic behaviors. For example, the rights attached to securities give investors the power to extract from managers the returns on their investment. Shareholders can vote out the directors if they do not take care of shareholders' interest. Bondholders can bankrupt the firm if they are not paid

interest and principal. Without these rights, firms would find it harder to raise external finance and hence no investment or production activities can be carried out (La Porta & Lopez-De-Silanes 1998). Whoever owns the assets and therefore bears the risks and retains the right to the residual rewards from production is important because it is this person(s) that fundamentally determines the allocation of scare resources. The issue of property rights brings into relief the theoretical underpinnings for future research in corporate governance (Aghion & Tirole 1997).

3.0 ORIGIN OF AGENCY THEORY - SEPARATION OF OWNERSHIP AND CONTROL

3.1 Theoretical underpinnings for the extant research in corporate governance come from the classic thesis, *"The Modern Corporation and Private Property"* by Berle & Means (1932). The thesis describes a fundamental agency problem in modern firms where there is a separation of ownership and control. Such separation has been clearly expressed by the authors' own statements: -

"It has often been said that the owner of a horse is responsible. If the horse lives he must feed it. If the horse dies he must bury it. No such responsibility attaches to a share of stock. The owner is practically powerless through his own efforts to affect the underlying property. The spiritual values that formerly went with ownership have been separated from it…the responsibility and the substance which have been an integral part of ownership in the past are being transferred to a separate group in whose hands lies control."

3.2 Adam Smith (Smith 1937) makes a caustic remark about the agency problem:-

"The directors of such companies, however, being the managers of other people's money than their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private co-partnery frequently watch over them…Negligence and profusion, therefore, must always prevail more or less, in the management of the affairs of such a company."

3.3 The agency problems, however, are the necessary evils of "*efficient form of economic organization*" (Fama 1980) that gives rise to separation of ownership and control.

3.4 Jensen & Meckling (1976) further define agency relationship and identify agency costs. Agency relationship is a contract under which "*one or more*

persons (principal) engage another person (agent) to perform some service on their behalf, which involves delegating some decision-making authority to the agent'. Conflict of interest between managers or controlling shareholder, and outside or minority shareholders refer to the tendency that the former may extract "*perquisites*" (or perks) out of a firm's resources and less interested to pursue new profitable ventures. Agency costs include monitoring expenditures by the principal such as auditing, budgeting, control and compensation systems, bonding expenditures by the agent and residual loss due to divergence of interests between the principal and the agent. The share price that shareholders (principal) pay reflects such agency costs. To increase firm value, one must therefore reduce agency costs. This is one way to view the linkage between corporate governance and corporate performance.

3.5 Recent research also adds complexity to the issue on separation of ownership and control. La Porta et al. (1999) investigate the issue of "ultimate control" of firms in 27 wealthy economies and find that equity of relatively few firms are widely held and that owners enhance their control of firms through the use of pyramiding and management appointments, as well as through cross-ownership and the use of shares that have more votes. Voting rights of these owners consequently exceed their formal cash flow rights (right to receive dividend). This appears to have expanded the concept of control, which Berle & Means (1932) highlight as a type of rapidly moving third force, quite apart from ownership and management. Claessens et al. (2000) also note that control by single shareholder is a common sight in firms in Asia. As previous studies have mostly looked at immediate ownership and not ultimate control, future research that takes into account of ultimate control where applicable when examining the relation between ownership structure and corporate performance should be encouraged.

3.6 Also in the present context, agency problem can be described as a problem involving an agent, the CEO of a firm, the shareholders, and many other stakeholders such as creditors, suppliers, clients and employees, and other parties with whom the CEO engages in business on behalf of the firm. Boards and external auditors act as intermediaries or representatives of these different constituencies (Becht et al. 2002; Bernheim & Whinston 1986).

3.7 In summary, with its root in industrial and organizational economics, agency theory assumes that human behavior is opportunistic and self-serving. Therefore, the theory prescribes strong director and shareholder control. It advocates fundamental function of the board of directors is to control managerial behavior and ensure that managers act in the interests of shareholders.

4.0 WHAT IS CORPORATE GOVERNANCE?

4.1 After the above review on firm and agency problems, a look at some definitions of corporate governance is in order before we proceed to the following sections.

4.2 The Code of Corporate Governance produced by The Committee on Corporate Governance or CGC and adopted by the Ministry of Finance, Singapore (CGC 2001) defines corporate governance as "*the processes and structure by which the business and affairs of the company are directed and managed, in order to enhance long term shareholder value through enhancing corporate performance and accountability, whilst taking into account the interests of other stakeholders. Good corporate governance therefore embodies both enterprise (performance) and accountability (conformance).*"

4.3 La Porta et al. (2000) view corporate governance as a set of mechanisms through which outside investors protect themselves against expropriation by insiders, i.e. the managers and controlling shareholders. They then give specific examples of the different forms of expropriation. The insiders may simply steal the profits; sell the output, the assets or securities in the firm they control to another firm they own at below market prices; divert corporate opportunities from firms; put unqualified family members in managerial positions; or overpay managers. This expropriation is central to the agency problem described by Jensen and Meckling (1976).

5.0 WHY HAS CORPORATE GOVERNANCE BECOME SO PROMINENT TODAY?

5.1 Till these days, the well-known agency problems resulting from the separation of ownership from control (Berle & Means 1932; Jensen & Meckling 1976) still prevail in firms worldwide. Of late, organizations have been paying more attention to corporate governance. It is also noted that there is increasing intensity in research on this subject, particularly in the last two decades. Becht et al. (2002) identify several reasons for this. There are the world-wide wave of privatization of the past two decades, the pension fund reform and the growth of private savings, the takeover wave of the 1980s, the deregulation and integration of capital markets, the 1997 East Asia Crisis, and the series of recent well publicized corporate scandals and high incidence of improper activities by managers in the U.S and Europe.

5.2 Recent research (Core et al. 1999) suggest that firms with weaker governance structure have greater agency problems; that firms with greater agency problems allow managers to extract greater private benefits; and that firms with greater agency problems perform worse. Specifically in Asia, it has been shown that both before (Joh 2003) and after (Mitton 2002) the Asian financial crisis in1997, firms that paid heed to good corporate governance practices fared better and provided greater protection to shareholders, especially the minority shareholders.

5.3 In Asia, the prevalence of family ownership, government interference, relationship-based transactions and generally weak legal systems and law enforcement result in agency problems such as large deviations between control and cash flow rights and low degree of minority rights protection. Compounding the problem in Asia, the conventional corporate governance mechanisms such as takeovers and boards of directors are not strong enough to relieve agency problems. The group business and cross-holding structure further complicate agency problems. These agency problems and weak corporate governance, not only lead to poor firm performance and risky financing patterns, but are also conducive to macroeconomic crises (Claessens et al. 2002b), like the 1997 East Asia crisis. Therefore, agency problems and corporate governance in Asia warrant urgent attention

5.4 Yoshikawa & Phan (2001) note intensifying global competition and rapid technological changes result in lower price/cost margins which in turn force firms to focus on maximizing asset efficiency and shareholder value if they want to access funds to fuel growth opportunities. Also technological advances reduce transaction costs and the costs of information research, rendering global capital markets more accessible to investors. This has fueled global competition between capital markets and the evolution of corporate governance around the world.

6.0 CORPORATE GOVERNANCE MECHANISMS AND FIRM PERFORMANCE

6.1 INTERNAL MECHANISMS

6.1.1 Board Of Directors

6.1.1.1 The board of directors is an important institution in the governance of modern corporations. Fama & Jesen (1983) view the board as the apex of internal decision control systems of organizations. To date, the often-researched

mechanism has been the board of directors (Dalton et al. 1998; Zahra & Pearce 1989). In particular, studies on board composition and board leadership structure have accounted for the bulk of research on boards of directors.

(i) Functions Of Boards

In a comprehensive review of the literature on boards of directors, Johnson et al. (1996) outline three widely recognized functions of boards of directors, namely the control, service and resource dependence roles. Most literature on the control function of the board draws on agency theory, which emphasizes the separation of ownership (shareholders) and control (professional managers) inherent in modern corporations. From an agency theory perspective, boards represent the primary internal mechanism for controlling managers' opportunistic behavior, thus helping to align shareholders' and managers' interests (Jensen 1993). Service role entails directors giving expert views and strategic advice to the CEO (Dalton & Daily 1999; Lorsch 1995; Westphal 1999). Finally, the resource dependence perspective (Dalton & Daily 1999; Aldrich 1979; Pfeffer & Salancik 1978) views board as an instrument for sourcing critical resources such as financing, intelligence on industry information and competition, to create sustainable competitive advantage (Conner & Prahalad 1996). In addition, a prestigious board may add legitimacy to newly established firms (Au et al. 2000).

In Asia, most research seem to find that the resource dependence function is more pronounced than control and service functions in corporate boards. For example, Young et al. (2001) find that the resource dependence function of the boards of overseas Chinese firms in Hong Kong and Taiwan is more pronounced than control and service functions, which they attribute to the social norms and institutional environments facing these firms.

(ii) Board size

There is a view that larger boards are better for corporate performance because they have a range of expertise to help make better decisions, and are harder for a powerful CEO to dominate. However, recent thinking has leaned towards smaller boards. Jensen (1993) and Lipton & Lorsch (1992) argue that large boards are less effective and are easier for the CEO to control. When a board gets too big, it becomes difficult to co-ordinate and process problems. Smaller boards also reduce the possibility of free riding by, and increase the accountability of, individual directors. Empirical research supports this. For example, Yermack (1996) documents that for large U.S. industrial corporations, the market values firms with smaller boards more highly. Eisenberg et al. (1998) also find negative correlation between board size and profitability when using sample of small and midsize Finnish firms, which suggests that board-size effects

can exist even when there is less separation of ownership and control in these smaller firms. Mak & Yuanto (2003) echo the above findings in firms listed in Singapore and Malaysia when they find that firm valuation is highest when board has five directors, a number considered relatively small in these markets.

Boyd (1990) finds that in a more uncertain environment represented by *munificence* (measured by the abundance of resources in the environment and scarcity would imply a greater uncertainty regarding access to resources), *dynamism* (measured by variability in growth rates of firms), and *complexity* (measured by the number of firms in an industry group and disparities in market share among these firms), boards tend to be smaller, although they had an increased number of interlocks.

There is also evidence that board size, together with other features of a board, is endogenously determined by other variables, such as firm size and performance, ownership structure, and CEO's preferences and bargaining power (Hermalin & Weisbach 2001).

(iii) Outside directors/board independence

Though the issue of whether directors should be employees of or affiliated with the firm (inside directors) or outsiders has been well researched, no clear conclusion is reached. On the one hand, inside directors are more familiar with the firm's activities and they can act as monitors to top management if they perceive the opportunity to advance into positions held by incompetent executives. On the other hand, outside directors may act as "professional referees" to ensure that competition among insiders stimulates actions consistent with shareholder value maximization (Fama 1980).

Fields & Keys (2003) conduct an extensive review of empirical research on outside directors and find overwhelming support from researchers (Brickley & James 1987; Weisbach 1988; Byrd & Hickman 1992; Brickley et al. 1994) who support the beneficial monitoring and advisory functions to firm shareholders. Latest study by Uzun et al. (2004) also finds that higher proportion of independent outside directors is associated with less likelihood of corporate wrongdoing among U.S. companies. However, there appears no conclusive evidence that insider/outsider ratio is correlated with firm performance (Hermalin & Weisbach 2001) and there are evidence supporting as well as disagreeing that firms with more independent directors achieve improved firm performance (Bhagat & Black 2002; Bhagat & Black 1999; Bonn 2004). Baysinger & Butler (1985) advocate a mix of insiders and outsiders on the board and find empirical support that this approach enhances firm performance. Agrawal & Knoeber (1996) suggest that

boards expanded for political reasons often result in too many outsiders on the board, which does not help performance.

Perhaps, one sensible approach is to assess the firm profile and the roles expected of the directors before deciding on the issue of outsider directors. Deli & Gillan (2000) find that firms with lower managerial ownership (of shares) and fewer growth opportunities are more likely to have independent and active audit committees. On the other hand, Matolcsy et al. (2004) discover among the larger Australian listed companies with valuable growth options, outside directors do add value to firms. Oxelheim & Randoy (2003) posit that appointing outsider Anglo-American directors who represent the more demanding Anglo-American corporate governance system, is likely to signal to foreign investors a commitment to corporate transparency and thus help strengthen investor confidence and enhance the international orientation of the firm. They find significantly higher sensitivity between firms based in Norway and Sweden with outside Anglo-American directors and firm performance measured by Tobin's Q (Chung & Pruitt 1994), computed as the ratio of the sum of market value of equity, book value of preferred stock and debt, divided by the book value of total assets. Klein (1998) examines board committees by classifying committees according to the two primary roles of directors: monitoring and decision-making (advising managers). She finds that firms increasing insider representation on committees associated with decision making e.g. finance and strategy committees have higher contemporaneous stock returns and return on investment.

Like board size, empirical studies on outside directors is complicated by the endogeneity problem (Hermalin & Weisbach 2001). For example, Hermalin & Weisbach (1988) find that outside directors are more likely to join a firm after poor performance, when firms leave product markets, or when a new CEO is chosen. Mak & Li (2001) find evidence that the proportion of outside directors of Singapore publicly listed companies is negatively related to managerial ownership, government ownership and board size.

(iv) Board leadership and CEO-chairperson duality

Financial economists have paid considerable attention to the role of boards in monitoring managers and in removing non-performing CEOs. Jensen (1993) voices his concern that a lack of independent leadership makes it difficult for boards to respond to failure in top management team. Fama & Jensen (1983) also argue that concentration of decision management and decision control in one individual reduces board's effectiveness in monitoring top management.

Relating CEO duality more specifically to firm performance, researchers however find mixed evidence. Daily & Dalton (1992) find no relationship between

CEO duality and performance in entrepreneurial firms. Brickley et al. (1997) also show that CEO duality is not associated with inferior performance. Rechner & Dalton (1991), however, report that a sample of Fortune 500 companies with CEO duality has stronger financial performance relative to other companies. Goyal & Park (2002) examine a sample of U.S. companies and find that the sensitivity of CEO turnover to firm performance is lower for companies when CEO and chairman duties are vested in the same individual, implying that board monitoring of top management is less effective in firms with CEO duality.

Faleye (2003) perhaps presents an interesting proposition. He argues that no "one hat fits all" and board leadership structure depends entirely on individual firm characteristics such as organizational complexity, availability of other controls over CEO authority and CEO reputation and power. Using a sample of 2,166 U.S. companies, he finds that companies with complex operations (implying need for CEO to make swift actions), alternative control mechanisms and sound CEO reputation are more likely to have CEO duality.

Due to recent corporate scandals in U. S. and high incidence of improper insider activities, more regulatory agencies appear to lean towards the opposition of CEO duality, e.g. NYSE's recent split of CEO and Chairman roles. However, as the above research show, more theoretical and empirical work perhaps need to be done first in order to better understand the advantages and disadvantages of different board leadership structure in different environments.

(v) Interlocking directorates

Interlocking directorate occurs when a person from one company sits on the board of directors of another company and in the most stringent definition, when current senior managers and/or directors of two companies simultaneously serve on each other's boards.

Interlocking directorates may exist for class integration, defined as the mutual protection of the interests of a social class by its members (Koenig & Gogel 1981). This process is driven by the identification and appointment of director candidates with similar backgrounds, characteristics, and political beliefs from within the personal networks of incumbent board members. The result of this "class hegemony" is an elite class of directors whose primary interactions in the boardroom serve the purpose of protecting class welfare (Koenig & Gogel 1981; Useem 1982). For example, Useem's (1982) interviews with 1,307 U.S. and British executives and directors uncover an elite network of directors in various organizations loosely held together by the common goal of preserving their individual and collective positions in society.

Another theory that holds interlocking directorates is resource dependence whereby directors could exchange resources, e.g. capital, industry information, and market access, to buffer the effects of environmental uncertainty (Pfeffer & Salancik 1978).

These two different motivations have very different performance implications. Interlocks designed to protect a managerial class have no *a priori* implication for firm performance while those designed to reduce environmental uncertainty would allow firms to access resources, information and legitimacy and hence enhance firm performance (Mizruchi 1983; Schoorman et al.1981). Evidence for the latter case has been provided by recent empirical case study in Singapore (Phan et al. 2003) whereby positive relationship between interlocks and firm performance was found for inter-industry (implying resource dependence perspective) but not for intra- and regulatory- interlocks.

(vi) Multiple board appointments

The issue of multiple board appointments attracts considerable debate. Some shareholder activists criticize multiple board appointments because directors who hold such appointments are ineffective in discharging their function to monitor managers. Several institutions in U.S. such as The Council of Institutional Investors and National Association of Corporate Directors generally advocate that directors with full-time jobs should not serve on more than two or three other boards. The Business Roundtable in Washington, DC, by contrast, believes that limits on the number of directors are ill advised. Ferris et al. (2003) find no evidence that multiple directors shirk their responsibilities to serve on board committees and no significant evidence of a relation between multiple directorships and the likelihood that the firm will be named in a securities fraud lawsuit. Cook (2002), who retired as Chairman and CEO of Deloitte & Touche LLP in 1999 and has taken board seats at five major American companies as a professional director, commented that "there is considerable value in being on multiple boards… and the experience across boards can be of real value to the governance process".

(vii) Frequency of board meetings

Vafeas (1999) finds that the annual number of board meeting increases following share price declines and operating performance of firms improves following years of increased board meetings. This suggests meeting frequency is an important dimension of an effective board. Lipton & Lorsch (1992) find that the most widely shared problem directors face is lack of time to carry out their duties. Conger et al. (1998) find board meeting time is an important resource in improving the effectiveness of a board.

Yet, an opposing view is that board meetings are not necessarily useful because the limited time the outside directors spend together is not used for the meaningful exchange of ideas among themselves or with management (Jensen, 1993), a problem that is a byproduct of the fact that CEOs almost always set the agenda for board meetings.

(viii) Board Processes and Behaviors

Recent reviews of board literature indicate that a predictive power of parsimonious models has failed to materialize (Johnson et al. 1996). This has reinforced Pettigrew's (1992) point that it is necessary to go beyond the direct board composition-performance approach to understand fully the performance implications of board demography and characteristics.

Researchers and practitioners alike are seeking to better understand how board processes and behaviors affect board performance. To facilitate future empirical research, Forbes & Milliken's (1999) work in proposing a model of board processes consisting of constructs such as effort norms, cognitive conflict and board's ability to tap the knowledge and skills that link board characteristics with firm performance is one such effort in this new research direction.

However, obtaining reliable data on board conduct and processes for empirical research is a challenging task

6.1.2 Director And Executive Compensation

6.1.2.1 An often-suggested internal solution to the problem of inefficient or self-serving management is the development of compensation plans that tie **management** compensation directly to firm performance, e.g. through stock price performance. This pay-for-performance plan generally helps to reduce agency problems in the firm (Morgan & Poulsen 2001), as the votes approving such plan are positively related to firms that have high-investment opportunities. On the other hand, votes approving the plan are inversely related to negative features in some of the plans such as dilution of shareholder stakes. And, research also show that the use of incentive or equity-based compensation for CEOs (Harvey & Shrieves 2001) and for managers (Mehran 1995) is greater in firms with a higher percentage of outside directors on the board and in firms with higher non-affiliated stockholders own large blocks of stock. Harvey & Shrieves (2001) also find that incentive compensation is greater in firms with growth opportunities.

6.1.2.2 However, the relationship between such pay-for-performance compensation for management and firm performance is still not clear. While some research find a much stronger relationship between firm performance and

executive compensation (Hall & Liebman 1998), other research argue that managers can and do sometimes design compensation plans at the expense of shareholders (Core et al. 1999; Campell & Wasley 1999). Yeo et al. (1999) also find no significant evidence for the incentive effect of executive share option plans (ESOP) on stock price and operating performance of Singapore listed firms. Most researchers however note it is not clear what the optimal pay-performance tradeoff should be, in cases where such incentive is of benefit to the firm.

6.1.2.3 Corporate governance reformers and institutional investors have recently argued that firms can increase the monitoring of management by providing **directors** with a financial stake in the performance of the firm. Perry (1999) finds evidence that incentive-based compensation for directors influence the level of monitoring by the board and through such compensation, firms can align the interest of directors and shareholders. Perry also finds that the likelihood of a firm adopting a stock-based incentive plan for directors is positively related to the fraction of independent directors on the board. Hermalin & Weisbach (1998) also suggest that incentive-based pay for directors can increase the monitoring efforts performed by the board. Shivdasani (1993) provides evidence that ownership by unaffiliated outside directors is negatively related to the probability that a firm will be subject to a hostile takeover attempt.

6.1.2.4 When choosing the type of compensation, researchers also report that firms have to be sensitive to their own firm characteristics. Lambert & Larcker (1987), for example, report that greater stock-based compensation is used when accounting measures are noisy and when a firm is in early stages of investment with rapid growth in assets and sales. Yermack (1995) reports pay is more sensitive to stock value in companies with noisy accounting data or in companies facing cash constraints and less sensitive in companies that are regulated.

6.1.2.5 In short, the structure and level of pay-for-performance for managers and directors has been and will continue to be a topic of considerable controversy.

6.1.3 Managerial Ownership

6.1.3.1 The cost of large managerial shareholdings and entrenchment are formalized in the model of Stulz (1988), which predicts a concave relationship between managerial ownership and firm value. In the model, as managerial ownership and control increase, the negative effect on firm value associated with the entrenchment of manager-owners starts to exceed the incentive benefits of managerial ownership. The entrenchment costs of manager ownership relate to a managers' ability to block value-enhancing takeovers. McConnell & Servaes (1990) provide empirical support for this relationship among U.S. firms.

6.1.3.2 La Porta et al. (2002), using samples in 27 wealthy countries, find evidence in firms with higher cash flow ownership (right to receive dividends) by controlling shareholder improves firm valuation, especially in countries with poor legal investor protection. In Asian economies where control by single shareholder is a common sight in firms, Claessens et al. (2002b) also find that firm value increases with the cash-flow ownership of the largest and controlling shareholder, consistent with “incentive” effects. However, when the control rights (arising from pyramid structure, cross-holding and dual-class shares) of the controlling shareholder exceed its cash-flow rights, firm value falls, which is consistent with “entrenchment” effects. Baek et al. (2004) find evidence that Korean listed firms with concentrated ownership by controlling family shareholders experienced a larger drop in stock value during the 1997 financial crisis. Using listed firms in eight East Asian economies to study the effect of ownership structure on firm value during the 1997 Asian crisis, Lemmon and Lins (2003) also find evidence that stock returns of firms in which ownership is concentrated in top managers and their family members were significantly lower than those of other firms.

6.1.3.3 Firms are governed by a network of relations representing by contracts for financing, capital structure, and managerial compensation, among others. Himmelberg et al. (1999) show that managerial ownership and performance are endogenously determined by exogenous changes in the firm’s contracting environment. Moreover, after controlling both for observed firm characteristics and firm-specific effects, they can’t conclude that changes in managerial ownership affect firm performance.

6.2 External Mechanisms

6.2.1 Large Shareholders or Blockholders

6.2.1.1 Investors with large ownership stakes have strong incentives to maximize their firms’ value and are better able to collect information and oversee managers, and so can help overcome one of the principal-agent problems in the modern corporation – that of conflicts of interest between shareholders and managers (Jensen & Meckling 1976). Large shareholders also have strong incentives to put pressure on managers or even to oust them through a proxy fight or a takeover. Shleifer & Vishny (1997) point out that “Large shareholders thus address the agency problem in that they have both a general interest in profit maximization, and enough control over the assets of the firm to have their interest respected.”

6.2.1.2 Other researches (Holderness & Sheehan 1985; Barclay & Holderness 1991; Bethel et al. 1998) find that block purchases are followed by increases in share value and abnormally high rates of top management turnover. Consistent with the view that market for partial corporate control identifies and rectifies problems of poor corporate performance, Bethel et al. (1998) find that activist investors typically target poorly performing and diversified firms for block share purchases, and thereby assert disciplinary effect on target companies' plans in mergers and acquisitions, and keep target companies focus on their core competencies and competitive advantages.

6.2.1.3 However, Shleifer & Vishny (1997) caution that "Large investors may represent their own interest, which need not coincide with the interest of other investors in the firms, or with the interests of employees and managers". Woidtke (2002) also cautions that not all institutional monitorings are positively related to firm value, as some institutional investors such as administrators of public pension funds (as opposed to private pension funds) may focus on political or social issues other than firm performance. Thus, not all shareholders may benefit from the managerial monitoring by institutional investors.

6.2.2 Market for Corporate Control: Proxy Contests, Hostile Takeovers and Leveraged Buyouts

6.2.2.1 A great deal of theory and evidence support the idea that the market for corporate control addresses governance problems (Manne 1965; Jensen 1988). Market for corporate control gives investors power and protection in corporate affairs if there is no workable control relationship between shareholders and managers, and ensures competitive efficiency among corporate managers. Jensen (1986, 1988) argues that takeovers can solve the free cash flow problems, since they usually lead to distribution of the firm's profits to investors over time.

6.2.2.2 In a recent study of factors affecting the probability of quoted UK firms being acquired, Weir & Laing (2003) find that firms that were more likely to be acquired if they had higher institutional shareholdings, higher executive director shareholdings, greater non-executive director independence. The probability of acquisition of smaller firms is also dependent on CEO shareholding. These findings offer support for the incentive and monitoring hypotheses of agency theory.

6.2.2.3 While there is evidence that the hostile takeovers and leveraged buyouts of the 1980s in U.S. were typically followed by improved operating efficiency and shareholder value (Bhagat et al. 1990; Kaplan 1989), the

effectiveness of takeovers and leveraged buyouts as a corporate governance mechanism remains questionable. First, takeovers and leveraged buyouts can be expensive. As Grossman & Hart (1980) point out, the bidder may have to pay the expected increase in profits under his management to target firm's shareholders who otherwise may not give up the shares. Acquisitions may also increase agency costs when bidders overpay for acquisitions that bring them private benefits of control (Shleifer & Vishny 1993; Jensen 1993). Jensen (1993) shows that disciplinary hostile takeovers were only a small fraction of takeover activity in the 1980s in the U.S.

6.2.2.4 Dodd & Warner (1983) define proxy contests as "dissidents" attempt to obtain seats on a firm's boards currently in the hands of "incumbents" or "management". Minority shareholders with substantial holdings usually bring proxy fights. Manne (1965), and Alchian and Demsetz (1972) depict the proxy contests as an integral component of the control devices disciplining management.

6.2.2.5 Relating proxy contest to firm value, Dodd and Warner (1983) find share price performance around the time of the contests is positively associated with proxy contests whether or not "incumbents" are ousted. Mulherin & Poulsen (1998), in a study of shareholder wealth effects of proxy contests in U.S. between 1979 and 1994, find that proxy contests create value, that bulk of the shareholder wealth gains arise from firms that are acquired in the period surrounding the contest, and that for firms that are not acquired, the occurrence of management turnover has a significant, positive effect on shareholder wealth because firms replacing management are more likely to restructure following the contests.

6.2.2.6 Claessens & Fan (2002a) find evidence that in Asian countries where investor protection and investor activism are weak, stock markets are increasing the cost of capital for firms and the controlling shareholders and managers ultimately bear some of the agency costs. Phan and Yoshikawa (2000) find support for the usefulness of agency theory to Japanese companies when they accessed global equity markets, in that the rules of capital market discipline do affect managerial strategic behavior.

6.2.3 Legal System and Investor/Creditor Protection

6.2.3.1 In different jurisdictions, rules protecting investors/creditors come from different sources, including company, security, bankruptcy, takeover, and competition laws, accounting standards, and also regulations and disclosure requirements from stock exchanges.

6.2.3.2 Recent research suggests that the extent of legal protection of investors in a country is an important determinant of the development of financial markets. For example, La Porta et al. (2000) explain that the protection of shareholders and creditors by the legal system is not only crucial to preventing expropriation by managers or controlling shareholders, it is also central to understanding the diversity in ownership structure, corporate governance, breadth and depth of capital markets, and the efficiency of investment allocation. La Porta et al. (2000) however admit that reforming or improving such legal protection is a difficult task as the legal structure of a country is deeply rooted and in view of the existing entrenched economic interests. Leuz et al. (2003) also find empirical evidence in a study of 31 countries that corporate earning management (to mask firm performance) by insiders is negatively associated with the quality of minority shareholder rights and legal enforcement.

6.2.3.3 Relating legal protection to corporate valuation, La Porta et al. (2002) find evidence of higher valuation, measured by Tobin's Q, of firms in 27 wealthy countries with better protection of minority shareholders. This evidence indirectly supports the negative effects of expropriation of minority shareholders by controlling shareholders in many countries, and for the role of the law in limiting such expropriation. In Asian context, Claessens & Fan (2002a) confirm that the lack of protection of minority rights has been the major corporate governance issue and it is priced into the cost of capital to the firms. Similarly, Johnson et al. (2000) find evidence that the protection of minority shareholder rights matters a great deal for the extent of stock market decline during Asian financial crisis.

6.2.3.4 In a vivid comparison of firms from two investor protection environments but both listed on Stock Exchange of Hong Kong, Brockman & Chung (2003) contrast the Hong Kong blue chip stocks which operate in an investor protection environment comparable to that of Western Europe or North America and the China-based red chip stocks and H-shares which are exposed to China's legal system, they find that Hong Kong-based equities enjoy higher firm liquidity, measured by trading spread and volume, than their China-based counterparts. Such liquidity cost is ultimately reflected in stock valuation.

6.2.3.5 Daines (2001) presents yet another interesting case study on how corporate law can benefit shareholders. He suggests that Delaware law, by which more than 50% of the public firms in U.S. are incorporated, facilitates the sale of public firms, thereby improving firm value. One contributing factor is the relatively clear and mild takeover law and expert courts in Delaware.

6.2.4 Leverage or Debt

6.2.4.1 Leverage increases are used, apart for other purposes, as part of the target companies' defensive strategies in hostile takeovers. Empirical evidence (Safieddine & Titman 1999) supports that higher leverage ratios deter takeovers because they are associated with performance improvements. In particular, Safieddine & Titman (1999) find that the operating performance of former targets following failed takeover attempts is positively related to the change in the target's leverage ratio. They also document that failed targets that increased leverage the most decrease investment, sell off assets, reduce employment, and increase the focus of their firms, which supports the views expressed by Jensen (1986) on the positive role of debt in motivating organizational efficiency.

6.2.4.2 Jensen (1986), as a way to reduce agency cost relating to free cash flow, suggests "…debt creation enables managers effectively bond their promise to pay out future cash flows, …to motivate cuts in expansion programs and the sale of those divisions that are more valuable outside the firms…and not to waste cash flows by investing them in uneconomic projects…" and this control hypothesis is more important in organizations that generate large cash flows but have low growth prospects.

6.2.4.3 The control function of debt was appropriately further explained and expanded by subsequent research. Using a case study on L.A. Gear in U.S., DeAngelo et al. (2002) illustrate that debt covenants and debt maturity can constrain managerial discretion more effectively than does the pressure to meet cash interest obligations emphasized by Jensen (1986). L.A. Gear's highly liquid asset structure enabled it to meet its debt obligations and keep operating for six years despite prolonged losses. DeAngelo et al. therefore conclude "…Excess liquid assets can be used to satisfy a firm's short to intermediate-term cash obligations and buy time without improving operations, whereas accounting-based debt covenants such as minimum earnings and net worth constraints require operating improvements…" In the same vein, debt contracts with shorter maturities give managers less scope to buy time by using liquid assets to meet interest payments and provide more frequent oversight by suppliers of debt capital. Smith (1993) also documents that the possibility of technical default due to breach of accounting-based debt covenants affects among others, the investment policies of the borrower in potentially important way.

7.0 BOARD DIVERSITY

7.1 Diversity is defined as *differences* in the most literal form of the word but the term, according to Kahn (2002), has been transformed to a purposeful strategic direction where differences are valued. Differences can be associated

with age, gender, physical appearance, culture, job function or experience, disability, ethnicity, personal style, and religion.

7.2 There are strong conceptual and business propositions for diversity. A diverse workforce and diverse leadership within the firm can increase its competitiveness as a great variety of ideas and viewpoints are available for decision-making, attract a larger base of shareholders and employees, and help retain existing as well as potentially gain new minority consumers (Cox 1993). Cox & Blake (1991) show how managing cultural diversity can create a competitive advantage for firms in six areas. There are cost, resource acquisition, marketing, creativity, problem-solving, and organizational flexibility. Robinson & Dechant (1997) also present three business reasons for diversity. There are cost savings, winning competition and driving business growth. According to Robinson and Dechant (1997), in today's fast –paced global market, diversity tends to encompass differences in gender, ethnicity, age, physical abilities, qualities, and sexual orientation, as well as differences in attitudes, perspectives and background.

7.3 On corporate boards, the various types of diversity that may be represented among directors on the corporate boards include age, gender, ethnicity, culture, religion, constituency representation, professional background, knowledge, technical skills and expertise, commercial and industry experience, career and life experience (Milliken & Martins 1996). Forbes & Milliken (1999) provide a strong theoretical basis for enhanced board diversity in that they argue heterogeneous board benefit from cognitive conflict that result in a more thorough consideration of problem and solutions.

7.4 Institutional shareholders have in recent years sought to promote more diverse boards in corporate America. In the early 1990s, Teachers Insurance and Annuity Association College Retirement Equities Fund (TIAA-CREF), New York, one of the largest institutional investors in US, issued its "Policy Statement on Corporate Governance" that emphasized the desirability of diverse boards. More recently, TIAA-CREF highlighted that it considered diversity in "experience, gender, race and age" as a director qualification (TIAA-CREF 2000). California Public Employees Retirement System (CalPERS), another large institutional investor representing the financial interests of California state employees, also required board should consider "the mix of director characteristics, experiences, diverse perspectives and skills that is most appropriate for the company" (CaLPERS 1998).

7.5 In a report by The Conference Board, U.S. (Martino 1999) written with anecdotal evidence from some large corporations such as IBM, Ford Motor,

Nortel, Lucent, Sara Lee, Texaco, and DuPont, diversity has been cited as an imperative for business success. The report cites the shift in labor market demographics, turnover rates, and the productivity gains of heterogeneous teams as primary drivers for diversity. The report also suggests that the truly diverse company is one that has minorities and women at every level of the workforce including the board of directors.

7.6 In the area of regulations or professional codes, more countries are paying increasing attention on board diversity. For example for public listed companies, Canada expect boards "should engage in a disciplined process to determine, in light of the opportunities and risks (i.e. the environment) facing the company, what competencies, skills, and personal qualities it should seek in new board members in order to add value to the corporation" and boards "should actively look beyond traditional sources in seeking men and women with the right mix of experience and competencies"; Australia expect boards should comprise directors "with the appropriate competencies to enable it to discharge its mandate effectively" and Singapore expect boards "should comprise directors who as a group provide core competencies such as accounting or finance, business or management experience, industry knowledge, strategic planning experience and customer-based experience or knowledge". In a spirited argument that the Sarbanes-Oxley reform failed to recognize, let alone apply board diversity to improve board functioning, Ramirez (2003) relates how other nations have advanced ahead of U.S. For example, Israel requires boards of government companies to pursue gender diversity since 1993. Norway government recently mandated that women fill 40% of board positions by 2005. United Kingdom government also recently studied how boards would benefit from enhanced diversity.

7.7 Past studies on boards, in general, have emphasized the benefits of greater board diversity. In particular, resource dependence theorists argue that directors with diverse background and from different constituencies facilitate the acquisition of critical resources for the organization (Pfeffer 1972; Pfeffer and Salancik 1978). Agency theorists suggest that board diversity can indirectly or directly benefit organizations (Kosnik 1990). Drawing an important distinction between the proportion of outsider directors and diversity of board membership, Kosnik (1990, p.138) specifically argues that diversity among board member backgrounds "….may promote the airing of different perspectives and reduce the probability of complacency and narrow-mindedness in board's evaluation of executive proposals". This argument is consistent with others who have posited that the promotion of diverse perspectives can produce a wider range of solutions and decision-criteria for strategic decisions (Eisenhardt & Bourgeois 1988; Schweiger et al. 1986). Using outside director data at Fortune/Forbes 500 firms,

Westphal & Milton (2000) find that minority directors in terms of gender, race, education, functional and industry background can enhance their ability to exert influence on the focal board if they have prior experience of minority directors on other boards or social network ties to majority directors through common members on other boards. They further suggest that such minority directors have the potential to make valuable contributions to board decision making by providing unique perspectives on strategic issues that challenge the conventional wisdom among majority directors. In a study on Indian firms, Ramaswamy and Li (2001) find evidence that greater foreign directorship appears to be able to influence firms by discouraging unrelated diversification. Adams & Ferreira (2002), in using U.S. data, find that gender diversity of corporate boards provides directors with more pay-for-performance incentives and that the boards meet more frequently.

7.8 However, there are other studies that show board diversity may significantly constrain efforts to initiate strategic change in times of environmental turbulence. Board members bring their individual and constituencies' interests and commitments to the board (Baysinger& Butler 1985; Kosnik 1990). Differences among these interests, especially those that are based on occupational and professional affiliations (Powell 1991; Thompson 1967) are likely to lead to varying conceptions about proposed strategic changes. The greater the diversity of board interests, the greater the potential for conflict and factions to develop based on diverse definitions of organizational goals and policies (Clegg 1990; Powell 1991). In an empirical test on the hospital boards in health care industry in California State of USA, Goodstein et al. (1994) find that organizations with diverse boards, measured by occupational or professional background, are less likely to initiate strategic changes than those with homogeneous boards.

7.9 More recent empirical studies begin to look at how diversity in general and at board level might enhance or relate to firm performance (Fields & Keys 2003).

7.10 Keys et al. (2003) present empirical evidence supporting a relationship between diversity promoting activities of firms and expected future cash flows. Specifically they find filing of discrimination of lawsuits produce a negative and significant stock price reaction. Shrader et al. (1997) also find positive relationship between total percentage of women managers and some accounting performance of large Wall Street firms.

7.11 In probably the first research on the direct relationship between board diversity and firm value, Carter et al. (2003), in a study of *Fortune*1,000 firms, find significant evidence of a positive relationship between board diversity, proxied by the percentage of women and/or minority races on boards of directors, and firm

value, measured by Tobin's Q (Chung & Pruitt 1994). They also find that firms making commitment to increasing the number of women on boards also have more minorities on their boards and vice versa, and that the fraction of women and minority directors increases with firm size but decreases as the number of inside directors increases. Bonn (2004) also find that among Australian public firms, the ratio of female directors on the board, despite its low percentage, has a positive effect on firm performance measured by market-to-book ratio computed as the ratio of market capitalization to current book value of total assets.

7.12 Using US banking industry data, Richard (2000) provides further insight by demonstrating that positive impact of cultural or racial diversity in workforce (measured by Blau's (1977) index of heterogeneity) on firm performance is moderated by the firm's business strategy. He finds firms with racial diversity and a growth strategy experience higher return of equity than firms with the same diversity but no growth or downsizing strategy.

7.13 Notwithstanding above, empirical studies on the relationship between board diversity and firm performance remain sparse to date. One explanation is insufficient development of testable theory. Hermalin and Weisbach (2001) comment that board-specific phenomena are not quite explained by principal-agent models and note that current theoretical framework including agency theory does not provide clear-cut prediction concerning the link between board diversity and firm value.

7.14 With globalization bringing about diversity in clients, operations and market competition, it will be interesting to see how firms can respond to the challenge. More research on the impact of board diversity on firm performance is needed in helping firms understand how to establish a more effective and robust board. A more parsimonious corporate governance model integrating agency and resource dependence theories discussed in later section might also provide better insights on the relationship between board diversity and firm performance.

8.0 STEWARDSHIP THEORY

8.1 Although agency theory is the dominant perspective in corporate governance studies, it has been criticized in recent years (Hoskisson et al. 2000; Blair 1995; Perrow 1986) because of its limited ability to explain sociological and psychological mechanisms inherent of the principal-agent interactions (Davis & Thompson 1994; Davis et al. 1997). For example, outside directors as emphasized by agency theory, with only legal power, may not possess sufficient

expertise and seldom have close social ties with top managers. Stewardship theorists assume that managers are good *stewards* of the firms. They are trustworthy and work diligently to attain high corporate profit and shareholders' returns (Donaldson & Davis 1994). These *stewards* can co-operate and work closely with the principal to achieve a "*goal alignment*" (Davis et al. 1997). In an empirical study by (Tian & Lau 2001) among Chinese shareholding companies to contrast agency and stewardship theories, they find that the stewardship hypothesis received stronger support. At the methodological level, Tian & Lau (2001) use two different board composition measures, i.e. independent directors and affiliated directors, to highlight their differences in motivation, firm-specific knowledge, information advantage, interpersonal relationship and mutual trust with the managers, along which dimensions that agency and stewardship theories diverge from each other. CEO duality is also seen as a supporting attribute to the stewardship theory and used in the test by Tian & Lau (2001). Phan (2001) suggests that whether the assumptions of agency theory can be generalized to emerging markets, with their different sociological, economic, and developmental fundamentals, remains an important research question.

9.0 RESOURCE DEPENDENCE THEORY

9.1 One important board function is the provision of resources to the firm (Johnson et al. 1996). The theoretical underpinning of this function is based on seminal works of Pfeffer & Salancik (1978) on resource dependency. Pfeffer & Salancik (1978 p.163) note "when an organization appoints an individual to a board, it expects the individual will come to support the organization, will concern himself with its problems, will variably present it to others, and will try to aid it".

9.2 Resource dependence theory posits that the characteristics of the environment play a most important role in shaping decisions on board composition (Pfeffer & Salancik 1978). The external environment is a major source of uncertainty for decision-makers (Daft et al. 1988; Miles 1980). This uncertainty arises from many sources: lack of information, unpredictability of changes in different business sectors, and inability of the firm to forecast the direction and intensity of these changes (Hall 1982). Resource dependence theory posits a firm's success will be contingent on its ability to gain access and control over external resources (Aldrich 1979; Aldrich & Pfeffer 1976). Proponents argue that control of the external environment is a key determinant of firm performance (Katz & Kahn 1978; Hillman et al. 2000). Boards of directors are "vehicles for co-opting important external organizations" and "forms of inter-firm linkage used to manage the organization's relationships with the environment" and help reduce environmental uncertainty (Pfeffer & Salancik, 1978 pp.165-167; Pfeffer 1972).

9.3 Pfeffer & Salancik (1978) assert that there are four primary advantages resulting from environmental linkages provided by the boards: (1) provide specific resources, such as customers (Pennings 1980), capital (Mizruchi & Stearns 1988), the business elite (Useem 1984), and power in general (Pfeffer & Salancik 1978); (2) serve as boundary spanners (Zahra & Pearce 1989) providing channels for communicating information between external organizations and the firm: (3) aids in obtaining commitments or support from important elements outside the firms, act as a co-optive mechanism to extract resources and obtain support from external stakeholders critical to the organization's performance (Zahra & Pearce, 1989); and (4) play an important role in establishing and enhancing organizational legitimacy (Pfeffer & Salancik 1978 p.145; Zahra & Pearce 1989).

9.4 One of the basic propositions of resource dependence theory is that the need for environment linkage is a direct function of the levels and types of external dependence facing an organization. Corporate boards should reflect the environment of the firm (Hillman et al. 2000; Boyd 1990; Pfeffer 1972). As environment in which a firm operates changes, it is therefore expected that board composition should also change. Several studies report relationships between firm's environment and the degrees of linkage. Pfeffer (1972) reports proportion of outside directors was positively related to the level of environmental demands. Pfeffer & Salancik (1978) report a strong correlation between frequency of interlocking directorship and uncertainty due to competition. Boyd (1990) finds that boards tended to be smaller in a more uncertain environment, although they had an increased number of interlocks. Pearce & Zahra (1992) also show that increased environmental uncertainty was associated positively with both board size and outsiders' representation on corporate boards.

9.5 Interlocking directorates offer organizations the benefits that reduce environmental uncertainty (Schoorman et al. 1981). Unlike the traditional and rather simple insider/outsider distinction commonly found in agency theory, an implication of resource dependence theory is that the underlying patterns of board composition will be more finely grained in order to better match the dependencies the firm faces in a new and changing environment. Pfeffer (1972) studies board composition in relation to specific environmental characteristics. He finds that the percentage of attorneys on a board was related to the level of regulation, and representatives from financial institutions increased, as did the firm's capital requirements. More recent studies also provide empirical evidence on this. Hillman et al. (2000) develop taxonomy of directors based on expected benefits to be derived from and commonly observed characteristics of directors and came up with four categories of directors. They are insiders, business experts, support specialists and community influentials. Using data on US interstate passenger

airline industry, Hillman et al. report that with a shift from a regulated to a deregulated environment, firms strategically adapted and altered the board composition from insider and support specialist categories to business expert and community influential categories. In a study on the patterns of interlocking directorates in Thailand-based multinational enterprises (MNEs), Peng et al. (2001) suggest that as compared with non-MNEs, MNEs in Thailand employ most resourceful directors, measured by directors with networks more densely connected and occupy more central positions of these networks, and powerful directors such as military directors who, in Thailand context, can provide "political resources" to the MNEs, so as to enable these MNEs to manage the uncertain environment of international operations. Phan et al. (2003) find among Singapore public listed firms, a positive relationship between inter-industry interlocks (but not intra-industry and regulatory agency interlocks) and firm performance, a phenomenon well explained by resource dependence theory. This finding contradicts the wisdom from agency theory, which argues hat interlocks serve only to entrench management (Jensen 1993).

9.6 In viewing the resource dependence theory from interpersonal network perspective and in an exploratory study of companies in the United States and Australia, Nicholson et al. (2004) offer further insight by examining the personal links provided by interlocking directorships to a board and find that interpersonal links could be more significant than the traditional measures of inter-firm links in developing board's social capital.

10.0 INTEGRATING AGENCY AND RESOURCE DEPENDENCE THEORIES

10.1 More recently, some research begin to integrate agency and resource dependence perspective of a board in attempt to develop a more fully specified and parsimonious model to explain relationship between the board functions of monitoring and provision of resources, and firm performance. One such work is done by Hillman & Dailziel (2003).

10.2 Agency theorists assert that board's monitoring function is directly affected by board incentives without regard to board's ability to monitor. Resource dependence theorists contend that board's function of providing resources is a sole function of the board ability or so-called board capital, defined as skills, knowledge, experience and contacts of board members, excluding consideration of board incentives. Hillman & Daiziel (2003) combine these two theoretical perspectives and posit that board capital provides the *basis* for the two board's functions of monitoring and providing resources. This is consistent with the

empirical analysis by Carpenter & Westphal (2001) that the monitoring and advising capability of directors depends on strategic perspective and base of expertise provided by their appointments to other boards, and finding by Westphal & Milton (2000) that directors with different backgrounds and expertise should lead to less insular decision making by the board. Hillman & Daiziel (2003) further posit that board incentives only *moderate* the effect (both direction and magnitude) of and indirectly affect both the relationships between board capital and each of these two board's functions.

10.3 Using equity compensation and board dependence (degree to which insider and outsider directors with ties to CEO or the focal firm) as two prominent proxies for board incentives, Hillman & Daiziel (2003) show that compensating boards with equity not only helped align directors' incentives and interests with those of shareholders (Boyd 1994; Dalton et al. 2003) and made directors effective at monitoring (Beatty & Zajac 1994), but also improved board's motivation to provide performance-enhancing resources to the firm (Zald 1969).

10.4 On board dependence, Hillman & Daiziel (2003) argue that it creates a disincentive to monitor and hence affect negatively the relationship between board's ability to monitor (i.e. the board capital) and actual monitoring. Boards dominated by outside and nonaffiliated directors are therefore better monitors because they lack this disincentive to monitor. This is borne out by the fact that researchers, studying the monitoring function, have coalesced in their preference for boards dominated by independent outside directors (Brickley & James 1987; Weisbach 1988; Byrd & Hickman 1992; Brickley et al. 1994). On the other hand, Hillman & Daiziel (2003) comment that directors who are connected to the CEO or the focal firm have more of an incentive to provide advice and resources because they are likely to benefit when firm performance is maximized. Hillman & Daiziel (2003) relate to the empirical test by Westphal (1999) who find that social ties between the board and CEO increase the frequency of advice and counsel exchanges and enhance firm performance, despite existence of disincentive to monitor based on agency perspective. Among outside directors, *affiliated* outside directors may be especially helpful because they facilitate the social and/or professional ties between the firm and its stakeholders. Several works with Asian context provided empirical evidence on this. For example, work in China (Peng 2004; Park & Luo 2001; Peng & Luo 2000), Hong Kong (Au et al. 2000), Taiwan (Young et al. 2001), and Thailand (Peng et al. 2001).

10.5 A potentially insightful conclusion by Hillman & Daiziel (2003) is that the above contradictory effects of board dependence on each of the two board functions of monitoring and providing resources may explain why so many previous empirical studies of board dependence and firm performance based

largely on agency theory alone have yielded mixed or non-significant results (Hermalin & Weisbach 2001; Dalton et al. 1999). For example, the success of some family owned and run companies in Asia could be more appropriately explained, as shown by some empirical studies, by the resource dependence perspective of their boards being more pronounced than control perspective of their boards, which the researchers attribute to the social norms and institutional environments facing these Asian firms.

10.6 Lynall et al. (2003) provide another insight by linking a firm's life cycle and the predictive validity of agency, resource dependence and other theories such as institutional theory. They argue the board composition at the time of founding is likely to be the result of the relative power of the CEO and external financiers, and the stage of the firm's life cycle. They find that resource dependence theory is more applicable for a firm in the entrepreneurial stage (period during which a firm is seeking to achieve a survival threshold), and agency theory explains the board composition of a firm in formalization and control stage (period during which continued success and stabilization of a firm are central concerns) better.

10.7 More empirical research in integrating agency and resource dependence theories will help establish and eventually legitimize a more parsimonious corporate governance model to explain the relationship between board composition and firm performance.

11.0 CONCLUSION

11.1 Among the corporate governance mechanisms to address agency problems, board of directors has often been researched. This is understandable as the board of directors is the apex of internal decision control systems of organizations, and hence an important institution in the governance of modern corporations.

11.2 Among the characteristics and attributes of a board, board diversity is a relatively new and emerging area of research. There are strong conceptual and business propositions for diversity, for example, to provide the creativity, flexibility and competitiveness that an organization needs in order to cope with the increased environmental uncertainty brought about by intensifying global competition, rapid technological changes, and shift in the demographics of labor market as well as client base etc.

11.3 Most studies and anecdotal evidence to date generally affirm, on agency perspective of the board's control or monitoring function, that a more diverse board does help in a board's decision-making process through different perspectives and cognitive conflict, and in asserting board influence on management, though some studies highlight that board diversity may constrain prompt initiative to implement strategic changes in times of environmental turbulence. On resource dependence perspective of the board, a more diverse board including interlocking directorships offers the benefits that reduce environmental uncertainty, i.e. a more diverse board is better able to understand the environment and obtain resources to overcome environmental uncertainty. Recent empirical research, notably in US and Australia, find evidence of a positive relationship between board diversity and firm value. However, it must be pointed out that empirical studies on the link between board diversity and firm performance remain sparse, and research measures for board diversity so far remain limited and incomplete as they use merely percentage of women and/or minority races on boards of directors as proxies for board diversity.

11.4 Some recent research also begin to integrate agency and resource dependence perspectives of a board in attempt to develop a more parsimonious model to explain board functions and firm performance. Agency theorists assert that board's monitoring function is directly affected by board incentives without regard to board's ability to monitor. Resource dependence theorists contend that board's function of providing resources is a sole function of the board ability or so-called board capital, defined as skills, knowledge, experience and contacts of board members, without regard to board incentives. The integrated model combines these two theoretical perspectives and posits that board capital provides the ***basis*** for the two board's functions of monitoring and providing resources, and that board incentives only ***moderate*** the effect (both direction and magnitude) of and indirectly affect both the relationships between board capital and each of these two board's functions. Another important insight this integrated model offers is that it helps explain why many previous empirical studies of board dependence (degree to which insider and outsider directors with ties to CEO and the focal firm) and firm performance, based on agency theory, have yielded mixed or non-significant results. This is because contrary to agency theory, resource dependence theory advocates that board dependence increase the incentive for these ***affiliated*** directors to provide advice and resources to enhance the firm performance. These contradictory effects of board dependence on each of the two board functions of monitoring and providing resources might explain the mixed and non-significant research results on firm performance so far.

11.5 Other research point out the importance of environment linkage for a firm success and maintain that board composition should reflect the environment

a firm faces and types of external dependence a firm hopes to have. For example, study show that increased environmental uncertainty was associated positively with both board size and outsiders' representation on corporate boards. Other study also show that firms altered board composition in order to have the necessary board expertise to respond to specific environmental characteristics facing the firm. Yet, other research caution that board composition should also take into account of a firm's life cycle and stage of growth and development, e.g. a firm in the entrepreneurial stage fighting for survival is more likely to have a more pronounced board's role in providing resources and environmental linkages, while a firm in the matured and steady stage in more likely to have a board performing control and monitoring role.

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