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**Boards of Directors and Firm Performance:
Is there an Expectations Gap?**

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Abstract

Reflecting investor expectations, most prior corporate governance research attempts to find a relationship between boards of directors and firm performance. This paper critically examines the premise on which this research is based. An expectations gap approach is applied for the first time to implicit expectations which assume a relationship between firm performance and company boards. An expectations gap has two elements: A reasonableness gap and a performance gap. Seven aspects of boards are identified as leading to a reasonableness gap. Five aspects of boards are identified as leading to a performance gap. The paper concludes by suggesting avenues for empirically testing some of the concepts discussed in this paper.

Key Words: Boards of Directors; Expectations gap; Firm Performance

Introduction

Reflecting investor expectations, prior research attempts to relate firm performance and corporate governance, with little convincing evidence found to date (Larcker, Richardson and Tuna 2004). Although more recent work considerably expands the governance factors examined, it has only been able to find relationships with a minority of those factors (Bebchuk, Cohen and Ferrell, 2004; Brown and Caylor, 2004; Cremers and Nair, 2005; Gompers, Ishii and Metrick, 2003). There are mixed findings on the direction of causality between firm performance and corporate governance (Chidambaran, Palia and Zheng, 2006; Core, Guay and Rusticus, 2006; Lehn, Patro and Zhao 2005). These findings bring into question whether it is reasonable to expect to find a relationship between firm performance and corporate governance, and prompts a critical examination of the premise on which that research is based. As Merino *et al.* (1987: 749) has observed “*If posited relations do not isomorphically map to actual events, then a theory lacks ex ante descriptive power and the results of empirical tests become less meaningful*”.

This paper questions the assumption that good governance (as proxied by board of director variables) will lead to enhanced shareholder value. It is suggested that there is an expectations gap between what stakeholders (e.g. investors, regulators, researchers, the media, the public) expect and what boards of directors can reasonably contribute. This paper critiques this premise/assumption. It is posited that the lack of robust prior research findings is explained by this expectations gap. However, it is acknowledged that research design flaws also contribute to problems of prior research attempting to relate firm performance and corporate governance.

The paper continues by defining the term “*expectations gap*” and considers prior research on expectations gaps. The role of boards of directors is then considered. The confusion as to the role of the board, and the conflicting role of boards, are highlighted as these are likely to contribute to an expectations gap. As the context for considering an expectations gap is prior research, the issue/research question addressed in prior research is then set out. Possible misunderstandings of the role of boards are considered, analysed from an

expectations gap perspective. The paper concludes by making suggestions as to future research applying an expectations gap approach.

Expectations gap

An expectations gap is the result of differences in opinion or perceptions between two or more groups (Deegan and Rankin 1999). An expectations gap has two elements (Porter, 1993):

- *A reasonableness gap*: Gap between what is expected and what can reasonably be expected to accomplish
- *A performance gap*: Gap between can reasonably be expected and perceived actual achievements.

The term “expectations gap” has been applied in auditing research in relation to investor expectations that audited accounts are accurate, compared with the reality that auditors provide an opinion that the audited accounts show a true and fair view (but are not necessarily accurate).

There has been little research on expectations gaps in relation to issues of corporate governance. Ironically, Keasey and Wright (1993: 293) pointed to the expectations gap of auditors without extending it to boards/non-executive directors:

“Third parties have a key role to play in ensuring the accountability of directors and management, especially auditors and non-executive directors. This in turn raises the question of what their roles are expected to be and the difficulties in carrying them out. The existence of a gap between what auditors are legally required to do and what they are expected to do by society in general is one manifestation of the problem.”

Reay (1994) and Hooghiemstra and van Manen (2004) were first to suggest the term “*expectations gap*” (until then applied to external auditors) could be applied to boards of directors. Reay (1994) reports a survey of executive and non-executive directors, institutional investors, merchant bankers and brokers and uses the term “expectations gap” in relation to the differences in perceptions between executive and non-executive directors. Hooghiemstra and van Manen (2004) addressed the expectations gap issue

more explicitly and surveyed over 1,000 Dutch non-executive directors, employee representatives and institutional investors. They found a large number of statistically significant differences in relation to non-executive directors' responsibilities between the views of non-executives on the one hand, and the views of other stakeholder groups on the other hand. Interestingly, expectations of different stakeholder groups on non-executive director performance varied considerably. Hooghiemstra and van Manen (2004) point to the inherent limitations applying to non-executive directors to explain these findings. Some of these inherent limitations are discussed further on in this paper.

Langevoort (2003) extends the expectations gap notion to companies and to securities regulation. He argues that company managements deliberately create expectations amongst investors of company growth prospects, and managements' skills to deliver that growth. These deliberately created expectations may contribute to an expectations gap. Langevoort goes on to suggest that securities regulators such as the Securities and Exchange Commission in the US further contribute to an expectations gap among investors by suggestion strong integrity and transparency in capital markets that does not in fact exist. He talks about "*the creation of investment illusions, which managers guilefully exploit.*" (Langevoort 2003: 1140). He extends the expectations gap notion to outside directors, and puts them into the same category as investors, in the sense that CEOs see the board as a group whose expectations have to be managed just as investor expectations have to be managed.

Two parties need to be identified in relation to expectations gaps. In relation to audit expectation gaps, the parties are auditors on the one hand, and financial statement users (Alleyne and Howard, 2005), audit interest groups (Porter, 1993), jurors and students on the other hand (Frank, Lowe and Smith, 2001). McEnroe and Martens (2001) compare the perceptions of audit partners and investors.

Reay (1994) considers gaps between executive and non-executive expectations, while Hooghiemstra and van Manen (2004) examine expectations gaps between non-executive directors and stakeholders such as employee representatives and institutional investors.

Langevoort (2003) identifies (i) management-investors expectations gaps, (ii) CEO-outside directors expectations gaps and (iii) regulators-investors expectations gaps.

In the auditing literature, a number of different methodological approaches have been taken to research audit expectations gaps. The most common are quantitative postal survey instruments (Porter, 1993; Humphrey, Mozier and Turley 1993; Reay 1994; McEnroe and Martens 2001; Dewing and Russell 2002; Hooghiemstra and van Manen 2004). In-depth unstructured interviews (Alleyne and Howard 2005) and experiments (Kinney and Nelson, 1996; Nelson and Kinney, 1997) have also been used.

Most research has just two groups of respondents; for example, auditors and interest groups (Porter, 1993); audit partners and investors (McEnroe and Martens 2001); auditors and users (Alleyne and Howard 2005). Porter (1993) divided her interest groups into two categories; (i) financial community group familiar with the work of auditors and (ii) members of the general public. Teo and Cobbin (2005) examine the gaps in expectations between auditors and the judiciary. Kinney and Nelson's (1996) nonauditors were government audit office investigators. Nelson and Kinney (1997) used MBA students as proxies for financial statements users (i.e. potential investors/shareholders). Humphrey, Mozier and Turley (1993) had five groups of users: auditors, financial directors, investment analysts, bankers and financial journalists.

In questionnaire-based research, the expectations gap is measured as the difference in the means of different group responses. Some researchers also examine the relative scale of the differences.

In conclusion, a problem in corporate governance that requires more consideration is the expectations gaps that exist around boards of directors. Narrowing any expectations gap between participants in capital markets is important to maintain confidence in the proper functioning of these markets.

The categorisation of expectations gaps into reasonableness gaps and performance gaps described earlier is applied in this paper in analysing the role of company boards.

Corporate governance

Corporate structure has a major disadvantage arising from the separation of capital providers (shareholders) and capital users (management). Corporate governance mechanisms have evolved that help reduce – but never completely eliminate – the costs associated with the separation of ownership and control (Denis, 2001). The board of directors is the official first line of defence against managers who would act contrary to shareholders' interests. Romano (1996) describes the board of directors as the principle governance structure for shareholders in diffusely held firms. Daily, Dalton and Cannella (2003: 372) suggest that “*the board of directors is the most central internal governance mechanism*”. Newspapers and business commentary would tend to support this view in the coverage given to boards of directors as a governance mechanism, with other governance mechanisms not mentioned at all, or mentioned to a much lesser extent.

Role of company boards

The board of directors is charged with oversight of management on behalf of shareholders. Agency theorists argue that in order to protect the interests of shareholders, the board of directors must assume an effective oversight function. It is assumed that board performance of its monitoring duties is influenced by the effectiveness of the board, which in turn is influenced by factors such as board composition and quality, size of boards, duality of CEO/Chairman positions, board diversity, information asymmetries and board culture.

The board of directors legal construct was first introduced in company law in the 1844 Joint Stock Companies Registration and Regulation Act (Donaldson and Davis, 1994; Tricker, 1984). It is likely that legislators then (and now) introduced this legal mechanism not with the objective of creating/generating/enhancing shareholder value, but with the intention of protecting/safeguarding shareholder investments. Enhancing shareholder value and protecting/safeguarding shareholder assets are very different and often times

conflicting objectives. Ambiguities in law around the role of the board, and conflicts between differing roles of boards, are likely to contribute to an expectations gap. These areas of confusion and conflict are discussed in the paragraphs to follow.

Although boards of directors are a legal mechanism, laws are generally silent on their purpose. Views on the role of the board are mixed, and differ across jurisdictions. This inconsistency may derive from differences in laws and other regulations specifying board roles. The role of the board is set out in a variety of regulatory sources, including:

- Statute
- Common law (precedents set out in case law)
- Self-regulatory codes of practice

The corporate governance literature is not consistent on the role of company boards. Stiles and Taylor (2001:10) observe that there is a lack of consensus on what boards are actually supposed to do. The nature of the board's contribution, and crucially the expectations placed on it, depend on which theoretical perspective is adopted.

Table 1 (further on) summarises the various roles of boards (19 in total) in the literature (Cravens and Wallace, 2001: 3; MacCormac, 1985; Stiles, 2001: 635). The 19 roles identified can be categorised into three groups:

1. Strategy: the process by which directors shape the direction, future, vision, values of an organisation
2. Monitoring and control of managers (including hiring and firing of the CEO) and
3. Acquisition of scarce resources / providing support to the CEO

Duties and accountability of directors

Duties of directors are also relevant here. Courts apply two broad principles against which to assess the conduct of directors:

- *Duty of care and skill*: This derives from the Roman term *mandatum* and requires directors to act in a reasonable, prudent, rational way, as expected of a similar person in that position. Courts apply the “business judgment rule” (when conflicts of interest

are absent), which provides directors with the benefit of the doubt when things go wrong. Failure to exercise such care amounts to negligence in common law countries.

- *Fiduciary duty*: This is a duty to act honestly and in good faith (sometimes referred to as a duty of loyalty) and specifically addresses situations of conflict of interest. Insiders should not profit at the expense of the company. Breach of fiduciary duty exposes a director to liabilities, and damages will arise where the interests of the company have been adversely affected.

Accountability of directors is not a straightforward issue. In law (as outlined above), directors are accountable for their individual actions, yet they operate and make decisions collectively as a board (Pye, 2002). Individuals may behave differently in a group. Thus, there is a tension between the analysis of individual and collective board actions. Directors (like other groups of people) may do things acting together that they would never do alone (Myers, 1994). A board may be greater (or less) than the sum of its parts. Boards shape their organizations through all aspects of directors' communications, inside and outside the organization, implicit and explicit (Pye 2002).

To whom do directors owe their duty?

This is another area of confusion in the literature. A range of possibilities exist from duty to the company, to shareholders collectively, to shareholders only, and/or to shareholders and wider stakeholders.

Strictly speaking in UK law, directors owe their duty to the company, not to the shareholders. However, in the US the duty tends to be expressed as a duty to shareholders collectively (but this very much depends on individual circumstances). In most cases, this difference has no consequences in practice. However, in extreme cases (Enron comes to mind here), where directors focus on shareholders/shareholder value (in modern markets this is often an excessively short term perspective), they may compromise the very survival of the company through misplacing their duty to shareholders instead of to the company (or to shareholders as a collective group). Thus, duty to company implies a

longer-term perspective and a requirement for prudence in ensuring the survival of the company.

US perspective

As part of its corporate governance project, The American Law Institute (ALI) (1994) defines the objective and conduct of companies as follows:

- “(a) ...a corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain.
- (b) Even if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business:
 - (1) Is obliged, to the same extent as a natural person, to act within the boundaries set by law;
 - (2) May take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business
 - (3) May devote a reasonable amount of resources to public welfare, humanitarian, educational and philanthropic purposes.” (Section 2.01)

Thus, although shareholder primacy is the general rule, subsection (b) allows for reasonable ethical and charitable considerations to supersede shareholder primacy. A company should conduct itself as a social as well as economic institution (Eisenberg, 1993). Conversely, Williamson (1984) argues that shareholder value should be the sole criterion for firm effectiveness. The inclusion of other stakeholders’ objectives compromises efficiency and invites tradeoffs. Cox (1993) expresses the view that directors’ obligations should be more directly tied to shareholders rather than to a more diffuse stakeholder group.

European perspective

Denis and McConnell (2003) observe that the role of the board in many European states is not specified in law. Where the role is specified, it is often couched in vague language, e.g. “*manage, or supervise the management of...the business and affairs of a corporation*” (LeBlanc, 2001: 6). Denis and McConnell note that in many European countries shareholder value is not the only, or even the primary, goal of the board of directors.

To summarise, the following areas of confusion and conflict are likely to contribute to an expectations gap:

- The role of boards is not explicitly set out in law
- Regulation of boards comes from a variety of different sources
- There is a lack of consistency and consensus on the role of boards
- The theoretical perspectives adopted influence understandings of the role of boards
- Directors are accountable for their actions as individuals, yet they operate and take decisions as a group
- There are variations by jurisdiction as to whom directors owe their duties
- Boards of directors may have to made trade offs between stakeholders in the exercise of their duties

From the above brief discussion, the assumption that unfettered shareholder value is the 100% objective of boards and of individual directors is unrealistic, and is likely to lead to an expectations gap.

The research question

How do entrepreneurs, shareholders and managers minimise the loss of value that results from the separation of ownership and control? This dilemma forms the basis of research into corporate governance. Much prior research assumes that the purpose of the board is shareholder maximisation. This perspective is unlikely to reflect the expectations of a wider group of shareholders and stakeholders in companies.

The question examined in prior research is: Does corporate governance effectiveness lead to superior corporate financial performance? Firm performance is hypothesised to be a function of firm corporate governance mechanisms. Corporate governance is usually measured by reference to board effectiveness, and firm performance is assumed to be a function of some measure of board effectiveness proxied by some board characteristic assumed to be effective. Characteristics tested include the size of the board, the number of independent outside directors on the board, separation of the roles of chairman and chief executive, the number of women on the board, etc.

The issue at the heart of this paper is whether all groups with interests in boards of directors have the same expectations as those implicit in the prior research discussed above.

Expectations gap in research on company boards

As stated in the introduction to this paper, there are two elements to expectations gaps: a reasonableness gap and a performance gap. These are discussed below in the context of boards of directors. This discussion is not intended to exhaustively cover all the literature about board process and director characteristics. In this respect, the work of Finkelstein and Mooney (2003), Forbes and Milliken (1999), Ingley and van der Walt (2005), Pye and Pettigrew (2005) and Sonnenfeld (2002, 2004) might be consulted.

Reasonableness gap and company boards

In relation to boards of directors, there is a reasonableness expectations gap in relation to what is expected of boards and what boards can reasonably be expected to accomplish. Factors contributing to this reasonableness gap include:

- Lack of agreement on role of boards
- Some roles may negatively impact on company performance
- The board has a limited and restricted role compared with that of managers
- Shareholder value is not the only aspect of interest to directors
- Directors have a limited ability to monitor and control

Lack of clarity and conflicting role of boards

Understanding that the legal duty of boards and of directors is to the company and not to shareholders is fundamental to understanding how boards work.

If boards are effective their actions should be consistent with maximising value to shareholders. This is the premise of research on relating shareholder value and boards of directors. Is it a reasonable premise? Table 1 (see further on) lists the various roles (19 in total) identified in the literature for company boards. Directors contribute to these roles to

different extents. With such a multitude of roles, directors are likely to see their job as broader than merely increasing shareholder value.

The various roles of boards are often in conflict. For example, monitoring managers requires outside directors to be sceptical and somewhat distrustful. Setting strategy requires collaboration and trust between managers and outside directors. Blair and Stout (1999: 49) refer to the conflicting role of boards from the perspective of the competing interests of the various different stakeholder groups.

“mediating hierarchs charged with balancing the sometimes competing interests of a variety of groups that participate in public corporations”

Monitoring and control by boards varies with economic conditions. Mizruchi (1983) suggests that the exercise of control by boards may vary depending on the relative performance of the firm. Mizruchi (2004, p.614, fn 73) suggests that boards are passive when there is satisfactory performance and in boom times. However, the potential for boards to exercise power is always there, even though it may remain dormant for years.

“When the economy is strong and firms are performing well, the board has less need to monitor management, and managers may find it easier to take liberties in ways that they would not otherwise be able to do so...Once the boom ended, it was no longer possible to hide such behaviour [Enron-type scandals], and managers again became vulnerable, although as in the Enron case, boards did not always react in time to save the firm.”

Some roles may negatively or negligibly influence company performance

It is generally assumed that the role of boards is to increase shareholder value and that an effective board of directors will automatically lead to improved company performance. However, Donaldson and Davis (1994) posit that adoption of non-executive dominated boards might have negative effects on corporate profit and shareholder returns. A careful analysis of the roles of boards points to certain roles having a negative rather than positive effect on performance.

Shareholders are in need of agents to oversee and control management’s self-serving behaviour and to safeguard shareholders’ assets and interests generally. According to

Herman (1981) boards exercise control generally by functioning as constraints on management. Thus, rather than contributing to firm performance, this view has management driving firm performance, with the board imposing limits to the way in which managers are free to pursue shareholder value. Thus, the role of the board could be interpreted in this context as stopping managers stealing (profits or assets) from the shareholders. (Other authors also consider less direct personal benefits to managers including perks, shirking, entrenchment and empire building). The tendency of managers to steal may vary depending on whether economic conditions are good or bad (Johnson *et al.*, 2000). Stealing (or not) will only have a significant influence on the overall performance (profitability or value) of a firm if the dollar amount stolen is significant. It becomes harder to steal as the absolute amount stolen increases. If the amount stolen is significant the manager runs the risk of being caught and being punished. Even if boards are successful in preventing managers stealing from shareholders, will this come through as significantly improved firm performance? Thus, even if the board exercises control in this way, the effect on firm performance is likely to be negligible.

A tension in corporate governance regulation is between the cost (time and money) of systems of accountability versus the need to foster an enterprise culture to generate wealth for the business. In discussing the purpose of corporate governance being to check managerial self-serving behaviour, Short *et al.* (1999) question whether the devices, mechanisms, and structures to reduce self-serving behaviour hamper performance and, while improving accountability, actually reduce efficiency. It is possible that good governance, which provides control, might hamper performance and enterprise rather than contributing to enhanced shareholder value. Baysinger and Hoskisson (1990) argue that outside directors potentially have a negative effect on corporate entrepreneurship.

Table 1 summarises the various roles of company boards identified in the literature, and crudely classifies them according to whether they are likely to have a positive, neutral or negative effect on firm performance. Of the 19 roles identified, only 11 are expected to have a positive effect on performance. In the case of two roles, it is not clear whether the role has a positive or negative effect, so these roles are classified as having a neutral

effect on performance. Eight roles are more likely to have a negative effect on firm performance.

Table 1: Effect of roles of board of directors on firm performance			
	Effect on firm performance		
	Positive	Neutral	Negative
<i>① Strategy roles</i>			
1. Framing objectives and vision of the business	✓		
2. Formulating (with management) and reviewing company strategy	✓		
3. Setting tone at the top/ethical culture of the organisation			✓
<i>② Monitoring and control roles</i>			
4. Ensuring corporate survival (protecting shareholders' interests)			✓
5. Setting risk appetite of organisation			✓
6. Hiring, evaluating, and firing of CEO	✓ ^{rare}		
7. Specifying lines of authority of management and board (reserved functions)			✓
8. Monitoring and evaluating management	✓ ¹		✓ ¹
9. Controlling operations	✓ ¹		✓ ¹
10. Reporting to, and communicating with, shareholders	✓ ²		
11. Recommending dividends		✓ ³	
12. Evaluating board performance, and planning board succession		✓ ³	
13. Ensuring compliance with statutory and other regulations			✓
14. Reviewing social responsibilities			✓
<i>③ Service roles</i>			
15. Enhancing company reputation and prestige	✓		
16. Participating in relationships with outside bodies	✓		
17. Assisting organisation in obtaining scarce resources	✓		
18. Acting as ambassador for the firm	✓		
19. Providing support and wise counsel to CEO/senior management	✓		
	11	2	8
¹ These roles are included twice, as they are likely to have both positive and negative effects on firm performance. Monitoring performance and controlling operations will lead to better performance, but may also impose constraints on managers' freedom to generate shareholder value			
² Boards improve market performance by influencing the perceptions of potential investors (signalling theory perspective)			
³ These two roles are assumed to have neither a positive or negative effect on firm performance			

The reason these eight roles are likely to have a negative effect on performance is because (in various different ways) they act to curb management's freedom to generate shareholder value. For example, because the board has imposed a strong culture of compliance in the organization, management is required to observe all legal requirements. This could lead to a loss of shareholder value. For example, a good board will not permit management to bribe officials in a foreign country, where such behaviour is the norm. As a result, competitor companies that do not have such a strong compliance culture are

likely to be more successful in obtaining lucrative foreign contracts as their managements are permitted by poor governance standards to bribe local officials.

Role of management versus role of boards

Much of this discussion implies that directors are there first and foremost to protect shareholders' interests. The role of adding value by ensuring outstanding performance of the business is one more under the control of day-to-day managers than of the board.

Earlier in this paper three primary roles/groups of roles were identified for company boards: Strategy, monitoring and acquisition of scarce resources / providing support to the CEO.

Can these three roles be related to company performance? Of these three roles, the first (strategy) is most likely to lead to better firm performance. However, the extent to which the board (as opposed to management) is involved in strategy is questionable. For example, Pye (2002:157) states that boards are rarely the originators or formulators of strategy. Strategy is primarily shaped by executive directors, although non-executive directors do have a role to play in this process. If this is true, then it follows that the board's strategic input is limited, compared with that of management.

The distinction between the board directing, and management managing is important here.

Shareholder value not the only aspect of the firm of interest to directors

Board responsibilities may manifest more directly in other significant areas besides firm performance (Cravens and Wallace 2001). Most directors are aware of their monitoring role – controlling the agency conflicts between management and shareholders. However, it is not clear that this role extends to ensuring that all management decisions are consistent with enhancing shareholder value resulting in better corporate performance. Given the multiple roles identified in Table 1, many decisions are likely to be made by directors which are good for the company but which do not lead to increased shareholder

value. Ignoring third party effects is a weakness of agency theory. Third parties are those affected by the contract but who are not party to the contract. Individual board members are likely to take account of such third party effects, but by so doing they may not be enhancing shareholder value. Also contributing to an expectations gap is the assumption that shareholders are only interested in shareholder value and have no interest in third party effects. The growth of ethical funds suggests that such a singular view of shareholder objectives is inappropriate.

Limited ability to monitor and control

Researchers assume that boards can exercise considerable control over management. Yet boards are perceived to be a relatively weak monitoring device (Maher and Andersson, 1999). Again a careful analysis would show that the main method of boards exercising control is by hiring and firing a CEO which is a crude, once-off, limited ability to exercise control (see below).

The term “control” needs more discussion. There is a difference between control and managing. Control is “the power to affect managing of a corporation” (Kotz, 1978: 17), “the power to determine the broad policies guiding the firm” (Kotz, 1978: 1). Subordinates may be actively engaged in decision making while those in power appear on the surface to be inactive. Because the board is responsible for selecting, evaluating and removing management it sets the boundaries within which managerial decisions will occur (Mizruchi, 1983). As long as a board has the ability to remove management, then it has control. Herman (1981) suggests that boards have various degrees of latent power (such as firing the CEO) and this power is likely to be exercised in rare circumstances.

The board can be an effective disciplining mechanism, and as such can raise management’s game:

“While the president is reasonably sure that the outside directors will not raise any embarrassing questions, the very requirement of appearing before his directors, who are usually respected peers in the business world, is a discipline itself not only for the president but also for the insiders on the board and insiders who are not on the board. The latent possibility that questions might be asked requires that the top executives of the company

analyze their present situation and be prepared to answer all possible questions which might – but probably will not – be raised by friendly directors.” (Mace, 1971: 23)

“The mere existence of outside directors makes us think a little bit harder, makes us organize our thoughts. It sharpens up the whole organization.” (Mace, 1971: 24)

Romano (1996:285) refers to the difficulty for non-executives in exercising their monitoring role. She asks:

“Should, for instance, a monitoring board be expected to enhance performance on an ordinary day-to-day basis, or over some longer horizon period, compared to non-monitoring (insider-dominated) boards, or should we expect its comparative benefit to appear only in times of exigency, acting in a crisis intervention mode...”.

Romano (1996) goes on to posit that in a perfect world independent boards would have a continuous effect on management performance, reacting immediately to management’s slightest failure. But is this a reasonable expectation in the imperfect worlds in which we live? Her review of the literature points her to the conclusion that monitoring boards are important in extraordinary as opposed to ordinary (day-to-day) operations.

Pye (2002:159) finds that directors acknowledge the limits of their influence on company boards. This may relate to the key tension that boards act as a collective and it is difficult for individual directors to identify their unique contribution in isolation from the group dynamic. Pye (2002) cites the example of an experienced director who made a powerful and effective contribution on one board of a company performing well, and yet the same person on another board of a poorly performing company was not able to contribute in the face of a dominant CEO. Thus, a host of factors affect the actions and decisions on each board.

Differences in risk appetites of shareholders and directors

Risk appetite is the amount of risk exposure, or potential adverse impact from an event, that an organisation/individual is willing to accept/retain. Many shareholders have considerable risk appetites as they have the opportunity to diversify their risks by investing in a wide range of assets. Managers are more risk averse as their interests are tied to a single company (their employer). Directors are even more highly risk averse.

Not only are they (like management) tied to a single company, but the remuneration derived there from is relatively modest, while (arguably) their most valuable asset, their reputation, is dependent on the company not being the subject of a scandal. Thus, directors and to a lesser extent managers are more risk averse than shareholders. Rather than contributing to shareholder value, their risk-aversion may have quite a contrary effect.

Fama and Jensen (1983) and Bhagat, Brickley and Coles (1987) argue that outside directors possess an incentive to act as monitors of management as they wish to protect their reputations and avoid lawsuits. Association with a failing firm could be disastrous for a non-executive's career, whereas association with a mediocre or even poorly performing firm is unlikely to have the same reputational impact. Gilson (1989) found that board members of failed firms had significantly reduced chances of obtaining future board positions.

Board decisions are a result of consensus

Boards make decisions as a group and board decisions are therefore the product of consensus. Consensus decisions may not be the best decisions for the company. Board decision making may encourage groupthink, a situation in which people modify their opinions to reflect what they believe others want them to think. As a result, this may lead to groups making a decision that few or even none of the members individually think is wise. It can also lead to a few dominant individuals making all decisions. Battiston, Bonabeaus and Weisbuch (2003) demonstrate how director prior relationships influence decision outcomes.

Performance gap and company boards

In relation to boards of directors, there is a performance expectations gap as follows:

- Monitoring in practice is difficult
- Firing the CEO
- Board does not exercise day-to-day control
- Information asymmetry

- Non-independent boards
- Other limitations of boards

Monitoring in practice is difficult

Boards vary in their ability to monitor. Reay (1994) reported a survey which found that only 41% of institutional investors considered that non-executive directors were effective in a monitoring/watchdog role.

Firing the CEO

In deciding to fire a CEO (the ultimate power of a board) a range of CEO competencies exists (likely to assume a normal curve pattern). At what point of incompetence does the CEO fail the test such that the board is driven to fire the CEO? According to Mizruchi (1983) this board control function may include only a “bottom-line” ability to oust the CEO.

One of the interviewees in Mace (1971: 15) captures this sentiment as follows:

“The only decision which we as directors will ever make in that company will be to fire the president, and things have to get pretty awful before we would ever do that”.

But many outside directors funk this hard task.

“It takes an awful lot of guts for a board member to be on a board, see things he doesn’t like, and then ask the pertinent and discerning questions of the management. Such men are rare birds indeed. It takes more guts than most people have. What they usually do is say, ‘Life is too short, and I’ll resign from the board.’ Resigning, however, does not solve the company’s problems – only that of the director who doesn’t have the guts to stay.”
Mace, 1971: 61)

Boards hire the CEO. As a result, boards may have a conflict of interest in that subsequently firing the CEO suggests the board’s original decision was wrong.

Boards may fire managers, not because they are under-performing, but because it makes the board look strong and in command of a difficult corporate situation, and maybe to deflect blame from the board to the CEO (Wiersema, 2002).

Board does not exercise day-to-day control

The distinction between day-to-day management and directing companies is important in how directors exercise their duties. Management exercises day-to-day operating control, and the board exercises long run policy control. This distinction is enshrined in law. Case law provides that a director is not bound to give continuous attention to the affairs of the company but is expected to attend board meetings with reasonable regularity. Executives are responsible for day-to-day management. Non-executives should not interfere in day-to-day management and should limit their involvement to an oversight role. Denis (2001: 201) expands on this point when she says “*Alternatively, it may be that outside directors are not important in the day-to-day operations of the firm but that they are effective monitors during important discrete events...*”.

Management is expected to exercise day-to-day operating control, which gives them intimate knowledge of the business, putting the board at a disadvantage. The board’s input is limited compared with that of management.

Information asymmetry

Incompetent, devious managers may seek to conceal the truth by withholding accurate and timely information. In such circumstances, expert outside board directors are unable to act effectively (exercise control) when required to do so. External auditors should furnish the board with information but this may fail, and external auditors may feel closer to management than the board.

“Another difficulty in measuring management is that the outside board members can respond only or principally to the material and data which are presented. It should be noted here that appraising the president’s performance can be limited by what the president, who controls the sources of information, chooses to make available.” (Mace 1971: 30)

Boards are not independent

Boards are assumed to be more effective (at least at monitoring and control) if they are independent. There are a number of reasons why boards may not be independent.

- Selection and appointment of directors by management, not by shareholders (especially where shareholdings are diffuse),

“...I believe the basic cause for the decline of the board is the fact that many chief executives are not really convinced they want a strong independent group of directors.” (Mace 1971: 77)

“[The president] then will throw off the board those directors who can't, or won't, do along with his ideas. The president has to feel his way until he is satisfied that he can in effect dominate a majority of the board.” (Mace 1971: 78)

“What any new board member finds out very quickly in our company is that it is very difficult to do anything except go along with the recommendations of the president. Because directors who don't go along with them tend to find themselves asked to leave.” (Mace 1971: 79)

“In the companies I know, the outside directors always agree with management. That's why they are there. I have one friend that's just the greatest agreeer that ever was, and he is on a dozen boards. I have known other fellows that have been recommended to some of the same companies as directors, but they have never gotten anywhere on the list to become directors. Because if a guy is not a yes man – no sir, he is an independent thinker – then they are dangerous to the tranquillity of the board room. Company presidents are afraid of them – every damn one of them.” (Mace 1971: 99-100)

- Boards may comprise affiliated (e.g. former management, those with business relationships with the company) rather than outside independent directors,

Other limitations of boards

There are many other limitations of boards which have been discussed extensively in the literature and are summarised here:

- Outside, independent directors are part-timers who lack expertise, knowledge and information about the firm's business; executive directors are full-timers who lack independence.
- Directors sit on several boards and do not have the time for effective oversight.
- Prestige without substance:

“You’ve got to have the names of outside directors who look impressive in the annual report. They are, after all, nothing more or less than ornaments on the corporate Christmas tree. You want good names, you want attractive ornaments.” (Mace 1971: 90)

“An ounce of image is worth a pound of performance” (Mace, 1971: 105)

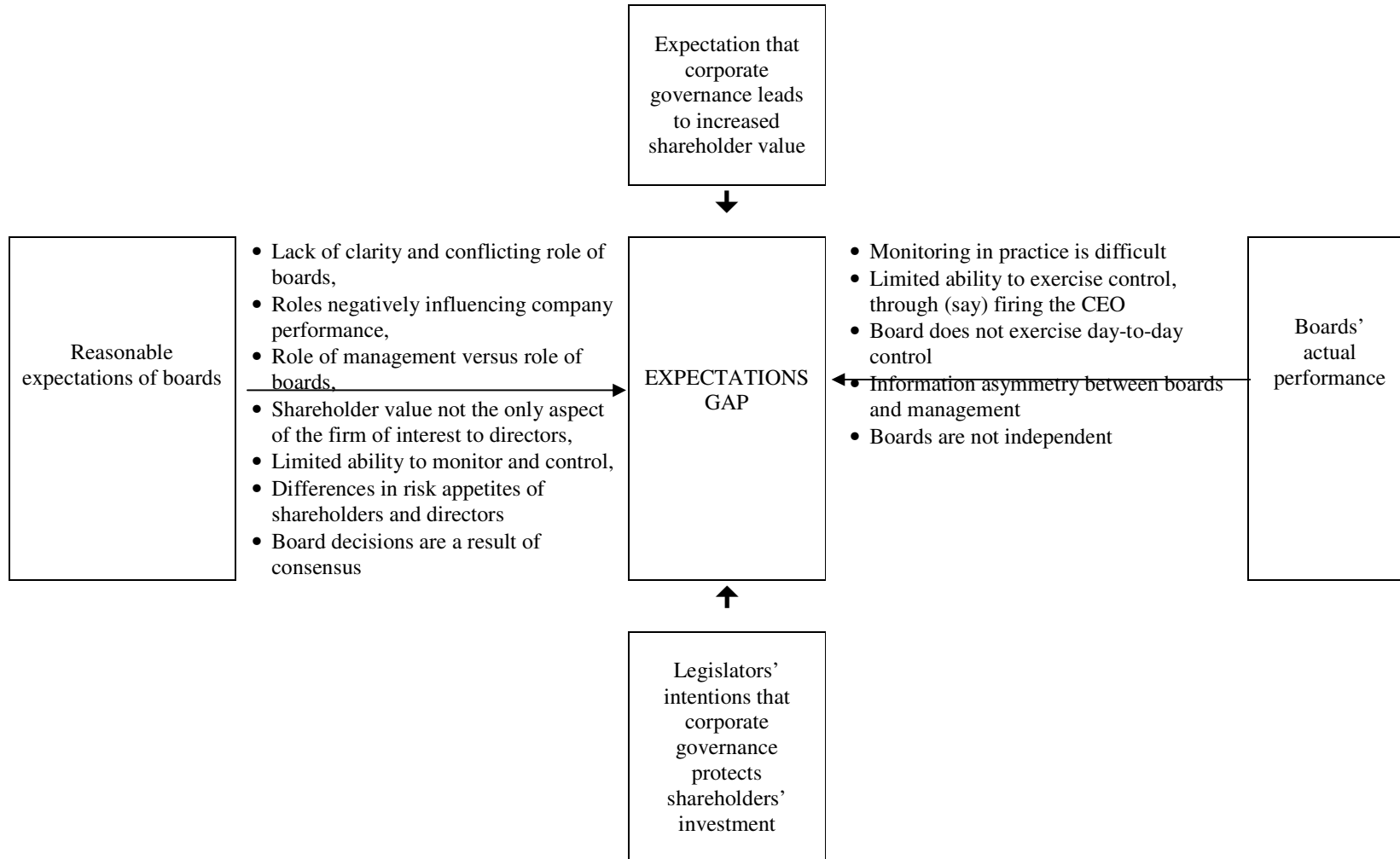
Figure 1 summarises the perspective taken in this paper.

Suggestions for future research

Much prior research is based on taken-for-granted assumptions about corporate governance. The existing evidence on many individual corporate governance mechanisms fails to establish a convincing link between these mechanisms and firm performance. It is possible there is no such link. Boards of directors may not have a meaningful impact on firm values. While boards may be an effective corporate governance mechanism in theory, Denis and McConnell (2003) state that in practice their value is less clear. Researchers might reconsider whether the assumptions of a relationship between corporate governance and firm value is justifiable. These are questions that must be addressed empirically.

In a discussion on the use of commercial governance metrics, Sonnenfeld (2004) concludes that it is the human dynamics around boards as social systems that really differentiates a firm’s governance, citing his earlier work (Sonnenfeld 2002) in this context. This points to a need for a different approach to researching governance, based on more qualitative approaches than some of the prior research cited above.

Figure 1: Expectations gap: The role of company boards and shareholder value



The expectations gap perspective discussed in this paper provides one way forward in attempting to improve our understandings of company boards. Porter's (1993) analysis of the structure of the audit expectations gap can be extended to boards of directors. Thus, the expectations gap in relation to company boards has the following components:

- A gap between what society (i.e. non-board interested parties) expects boards to achieve and what they can reasonably be expected to accomplish
- A gap between what society can reasonably expect boards to achieve and what they are perceived to accomplish. This can be divided into:
 - ◆ A gap between the duties than can reasonably be expected of boards and the requirements as defined by legal and other regulations
 - ◆ A gap between the expected standard of performance of boards' existing duties and the perceived performance of boards as expected by society.

Who are the subjects?

As was stated at the beginning of this article, an expectations gap is the result of differences in opinion or perceptions between two or more groups. Expectations gap research therefore must identify and select groups of subjects for research. Table 2 summarises a list of possible groups for research.

Table 2: Subjects for expectations gap research on company boards	
Group 1 (board of directors)	Group 2 (stakeholders)
Whole boards	<i>Within companies</i>
Board directors	Company management
Executive directors	Executive directors
Non-executive directors	CEOs
Board chairmen	
	<i>External stakeholders</i>
	Investors
	Institutional investors
	Investors from different countries
	Financial / investment analysts
	Legislators
	Regulators
	Bankers
	Academics
	Lawyers
	Financial journalists
	Members of the general public

Comparison of the views of subjects

Some possible permutations and combinations of groups for research are considered in Table 3. Expectation gaps in relation to corporate boards may be categorised between those that exist within the company, and those that exist between the company and outside stakeholders. Examples of within-company expectations gaps and external company expectations gaps are set out in Table 3.

In addition, there may not be homogeneity of views within groups, which needs to be considered. A first step in this kind of research is to test this assumption, before comparing the views of two or more groups. The views of individuals within specific groups would have to be compared before it could be concluded that they all share the same view of the world. If the board is a strong diverse board, diversity of opinions of the roles and responsibilities of the board may emerge. If the board has inexperienced directors, those individuals may not fully understand their roles and responsibilities.

A further consideration is whether the research would compare the composite views of two groups, or the views of individuals in two separate groups. In the past, expectations

of boards have been measured by surveying non-executive directors. However, it is well known that people in groups operate differently to individuals, and for this reason there may be differences in the expectations gaps of individual non-executive directors and those of boards as a whole.

Table 3: Combinations of subjects for expectations gap research on company boards	
<p>(1) Within-company expectations gaps <i>(1)(a) Within-group, within-company expectations gaps</i></p> <p>Individual board directors</p> <p>Individual executive directors</p> <p>Individual non-executive directors Individual senior managers</p> <p><i>(1)(b) Between-group, within-company expectations gaps (composite group views, or individual views)</i></p> <p>Whole board – Management team/ Management team members/executive directors/CEOs Board directors – Management team/ Management team members/executive directors/CEOs Non-executive directors – Management team/ Management team members/executive directors/CEOs Board chairmen – Non-executive directors</p> <p>Board chairmen – Management team/ Management team members/executive directors/CEOs</p> <p>Boards/Directors/Non-executive directors/Executive directors – Employees</p>	<p>External company expectations gaps</p> <p>Boards/Directors/Non-executive directors/Executive directors – Investors Boards/Directors/Non-executive directors/Executive directors – Institutional investors Boards/Directors/Non-executive directors/Executive directors – Financial / investment analysts Institutional investors – individual investors</p> <p>Boards/Directors/Non-executive directors/Executive directors – Legislators Boards/Directors/Non-executive directors/Executive directors – Regulators Boards/Directors/Non-executive directors/Executive directors – Bankers Boards/Directors/Non-executive directors/Executive directors – Creditors Boards/Directors/Non-executive directors/Executive directors – Academics Boards/Directors/Non-executive directors/Executive directors – Lawyers Boards/Directors/Non-executive directors/Executive directors – Financial journalists Boards/Directors/Non-executive directors/Executive directors – Members of the general public</p>

Different types of organisation

The discussion so far in this paper has assumed that companies under consideration are publicly-quoted companies. The expectation that the role of the board is to generate shareholder value may not be appropriate for other types of organisation such as state companies, public bodies, not-for-profits, family businesses, high-tech companies, charities etc. Interesting additional insights on variations in expectations gaps by

reference to type of organisation suggest that this type of research should be broadened beyond public companies.

Expectations gap research design

A wide range of research tools are possible in researching expectations gaps. The most common is postal questionnaires, but prior researchers have already acknowledged the limitations of these instruments (Humphrey, Moizer and Turley, 1993). A case study approach has also been applied examining the differences in actions taken under varying circumstances between different groups of respondent (Humphrey, Moizer and Turley, 1993). In-depth unstructured interviews have been used for expectations gap research (Alleyne and Howard 2005). Expectations gap research could also be pursued using case studies in the field, looking at expectations gaps between a myriad of subjects within a single organisation.

Issues to be addressed

Using prior research in external auditing as a guide, Table 4 broadly-speaking identifies some issues that might be addressed in board expectations gap research. Research may take particular duties or corporate governance functions of boards, and examine in a more focussed way any expectations gaps around these particular issues. Functions that are currently topical that come to mind include executive remuneration (where judging from media reporting, there is a considerable variation in expectations of society versus that of boards) and oversight of financial reporting.

Table 4: Issues to be addressed in expectations gap research on company boards

Duties / roles, / responsibilities of directors (which must be identified and listed)

- What are the existing duties of boards/directors?
- How well are the existing duties of boards/directors performed?
- Should this duty be performed by boards/directors?
- How do boards/directors trade-off between conflicting roles and responsibilities?
- What are the respective contributions of the board versus the non-executives versus management?

Attributes of boards/directors/management

- What constitutes good/bad governance? How should good/bad governance be measured?
- What constitutes good/bad quality boards? How should quality of boards be measured?
- What constitutes effective boards? How should board effectiveness be measured?
- What attributes of directors most closely associated with the performance of effective boards?
- What are the attributes of management most closely associated with the performance of effective boards?
- How do interactions between boards/directors and management influence board effectiveness?
- What are the attributes of management most closely associated with the performance of the company?
- What constitutes good/bad company performance? How should good/bad performance be measured?

Behaviour of management

- To what extent does management deliberately contribute to an expectations gap?

Behaviour of regulators

- To what extent do regulators mislead stakeholders about the integrity of capital markets, thereby contributing to an expectations gap?

Some of the issues outlined in Table 4 are discussed further below.

Boards of directors

Researchers in the past have made crude value judgements to distinguish good and bad governance. Earlier studies distinguished good and bad by reference to simple metrics such as the proportion of outside directors on the board, separation of the role of chairman and chief executive, etc. More recent studies have included multiple metrics such as Larcker, Richardson and Tuna (2004) (38 governance measures); Bebchuk, Cohen and Ferrell (2004) (24 governance measures); Gompers, Ishii and Metrick, 2003 (24 governance measures); Brown and Caylor, 2004 (51 governance factors). However, assumptions underlie the division of these metrics into good and bad with insufficient research supporting such value judgements.

This is an area that requires considerably more research. What is “good” governance? What makes a board “good”? How do we measure “good”? How should quality of the board be measured? How should the unique contribution of the board be measured?

The issue of conflicting roles of boards, and understanding the expectations of different subjects around the trade-offs to be made in such circumstances, is likely to be a rich source of material to contribute to the varied understandings of board processes. Earlier, 19 different roles for boards were identified, many of which are conflicting. How do boards/individual directors make trade-off decisions in relation to their various different (conflicting?) roles? This is an issue that requires further investigation.

Future research should more explicitly recognise the conflict for company boards between protecting shareholder interests on the one hand and generating shareholder value on the other. The best measure of protection of shareholder investments is firm survival rather than long run shareholder returns. In fact, prior research has shown stronger and more consistent findings on the relation between corporate governance and firm performance where firm performance is proxied by financial distress or firm survival (Daily and Dalton 1994; Elloumi and Gueyie 2001; Hambrick and D’Aveni 1992; Pfeffer 1972) rather than shareholder value.

There is a growing belief in business that performance cannot be encapsulated in a single performance number, and that a balanced-scorecard approach is more appropriate to capture the multi-faceted contributions of businesses and individuals. More qualitative research approaches, such as those suggested earlier, might allow researchers to take account of effects that cannot easily be captured using modelling and empirical testing thereof.

Related to this is the question of whether the objective of a company should solely be to generate profit or shareholder value, or whether wider corporate objectives should also be included. Maybe generation of shareholder value should not be the uncompromising objective of companies. Should we expect, first and foremost, that our companies are

corporate good citizens (even if this is at the expense of shareholders), followed by efficient generation of shareholder value? Qualitative research, such as questionnaires, in-depth interviews, case studies and field study work, might be applied to expand the more usual agency theory approaches of prior research to include third party effects of corporate behaviour, and the influence of corporate governance thereon.

Contribution of management

Prior research has placed too much faith in the performance of company boards. What is the contribution of management, versus the contribution of the board? Is the contribution of management to generate shareholder value, and the board to protect shareholder investment? To what extent do boards of directors contribute to firm survival rather than to shareholder value? This paper tends to assume that company management rather than company boards have the primary role in generating shareholder value. For this reason, senior management is paid in the form of share options, to motivate them to perform well in generating shareholder value. Conversely, modern corporate governance prohibits paying non-executive directors in the form of share options (e.g., Code provision B.1.3 of the Combined Code 2003). This implicitly acknowledges that the role of non-executive directors is not primarily to generate shareholder value.

Does the contribution of management depend on the quality of management? It cannot be assumed that all company managements are equally effective (however effective is defined). For these reasons, future corporate governance research must include some measure of management competence rather than or in addition to a measure of board effectiveness. How should quality of management be measured? Should a single measure or multiple measures be used?

Prior corporate governance research tends to treat boards and management as a single variable. Greater recognition should be made that the contribution of boards and of management are different. Research should include metrics to capture their respective contributions. Variables capturing the contribution of board and of management need to be included together in models of governance. Research designs need to be developed

that isolate the impact of management versus that of boards and to facilitate the direct examination of the differential contributions of management and boards. Many leadership characteristics have been used in prior research to try and explain firm performance. Characteristics of CEOs (Dominance, charisma, transactional leadership, etc) have been examined although findings have not been conclusive (Ashley and Patel, 2003)

Is the contribution of management independent of the contribution of the board or are there interaction effects between the two? Do boards and management act in a complementary way? More refined measures could be developed that capture the interaction effects of boards and management.

Shareholders

Boards act on behalf of shareholders. But do boards know what shareholders want? What do shareholders want from a board of directors? (shareholder value, modified shareholder value (modified by corporate responsibility objectives), firm survival?). Research into the effectiveness of company boards is impossible without clarity around these questions.

To complicate matters, there are different types of shareholders. Do all shareholders want the same from a board of directors? Institutional versus individual shareholders; Shareholders from different countries; Shareholders from different cultural backgrounds, etc. Institutional shareholders represent individual shareholders (pensioners, individual investors, etc). Do institutional shareholders know what is expected of them by their underlying investors (e.g. pensioners) in terms of their relationships with, and expectations of, boards of directors?

How are institutional shareholders remunerated? Are they remunerated in a manner that reflects shareholder's expectations? Are institutional shareholders motivated to perform as expected by underlying investors (e.g. pensioners with longer term horizons)?

Other issues

In relation to all of the issues for future research, it cannot be assumed that they apply in the same way across all jurisdictions. Are there any cross-cultural, cross-country variations in these issues?

Concluding comments

This paper questions whether generating wealth for shareholders is the sole or even prime role of boards of directors. The academic community is reluctant to conclude that there is no relationship between firm performance and boards of directors. For example, Gillies and Morra (1997: 77) referring to board structure state “Common sense tells us that there is a relationship between corporate governance and firm performance”. LeBlanc (2001) has surveyed directors and an overwhelming majority were of the opinion that boards do contribute positively (and in some cases negatively) to the bottom line.

Ambiguities around the role of boards in regulations and in the academic literature suggest that directors may have a tempered approach to revenue generation. Unfettered assumptions that directors have shareholder value as their number one priority may not be valid in practice. The board may see its role as primarily to protecting (not generating) the shareholders’ investment by ensuring the survival of the company. Directors may have to make tradeoffs between the amount of risk management should take in generating shareholder value versus the stability and survival of the company. Rather than asking whether good governance generates shareholder value, a more realistic question might be: Does good governance stop the destruction of shareholder value? Research might re-focus on the differences between failed and non-failed firms to see whether we have more to learn from bankruptcy.

Benefits of expectations gap research

This type of research could assist corporate governance in the following ways. It would assist regulators by providing inputs from investors and others involved in corporate governance in the development and clarification of corporate governance best practice standards. Regulators would be able to focus on areas where public perceptions are

perceived as not being met. Such research would provide evidence on further measures that need to be taken to reduce the expectations gap around company boards.

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