Effective corporate governance employs multiple strategies, study says

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The most effective corporate governance occurs when a mix of complementary mechanisms that include CEO incentive alignment and both internal and external monitoring mechanisms are present, according to a new study from Penn State Smeal College of Business faculty member Vilmos Misangyi and his colleague from the Singapore Management University.

Corporate governance refers to the collection of activities meant to help ensure that executives make the best decisions for shareholder profitability. While much past research has attempted to evaluate the effectiveness of each governance mechanism individually, Misangyi's study of the S&P 1500 firms instead takes a holistic view of how these activities work in concert to achieve profitability.

The two primary categories of governance mechanisms include incentive alignment and monitoring. Alignment mechanisms incentivize executives to act in the best interest of shareholders through, for example, CEO stock ownership and compensation contingent upon firm performance. Monitoring can occur from both internal and external sources, such as boards of directors and shareholders owning large blocks of equity, respectively.

"The effectiveness of the governance bundle requires the presence of both CEO incentive alignment and monitoring mechanisms," the researchers found. In fact, they continue, "All six of the different configurations [of governance mechanisms] leading to high profits …

include at least one of the CEO alignment mechanisms and at least one each of the internal and external monitoring mechanisms."

These findings go against the prevailing conventional views that governance mechanisms tend to substitute for one another (e.g., as long as incentives are present, monitoring need not be).

Two key implications pertain to board independence and CEO duality. Although board independence—a board made up of members without material or relational ties to the firm—tends to be beneficial, this monitoring mechanism is not effective by itself. Furthermore, whereas many governance reformers hold CEO duality—when the CEO is also the chairperson of the board—to be detrimental, the findings clearly suggest that both CEO duality and CEO non-duality can lead to high or low profits depending upon the accompanying governance arrangements.

The researchers conclude that future study and implementation of corporate governance should take into account the full configuration of governance mechanisms as they work together rather than attempting to evaluate effectiveness of those mechanisms individually.

"To truly understand governance effectiveness, we must stop thinking about the mechanisms in isolation, giving up a search for the end all mechanism(s), and instead direct attention to how the various governance mechanisms effectively combine with each other for the particular outcomes desired," the researchers wrote.

More information: The article "Substitutes or Complements? A Configurational Examination of Corporate Governance Mechanisms" is forthcoming in the *Academy of Management Journal* from authors Vilmos Misangyi, associate professor of management and organization in the Smeal College of Business, and Abhijith G. Acharya, assistant professor of strategic management at the Singapore Management

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