Corporate Governance: Strategic Role of Board of Directors and Its Effect on Financial Performance, Case Study: Auto Companies Listed in Tehran Stock Exchange

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Abstract: Abstract Corporate governance is a critical factor in efficiency improvement in any economy. It represents a collection of interactions among board of directors, corporate management, shareholders, and other stakeholders. Corporate governance provides a structure for development of corporate objectives, facilities to achieve those objectives, and means to supervise corporate performance. Corporate governance mechanisms are critical for company performance. This study examines the internal mechanisms employed by board of directors and their effects on financial performance through strategic planning. It uses a case study of auto companies listed in Tehran Stock Exchange. The role of board of directors in strategic management is determined by their degree of participation in strategic planning. In order to measure the role of board of directors in strategic management, this study used a questionnaire developed based on Hunger-Wheelen and Nadler Models. This questionnaire was distributed to 105 board members of auto companies listed in Tehran Stock Exchange. 75 questionnaires from 78 respondents were included in this study. Financial performance (Tobin's Q) was calculated based on corporate balance sheets. The study findings revealed a significant relation between the role of board of directors in strategic management and financial performance. It means that board of directors with catalyst role, active participation, or nominal participation in strategic management had positive effect on corporate financial performance. Conversely, board of directors with minimal review, rubber stamp, or phantom roles in strategic management had negative effect on corporate financial performance.

[Hossein Haji Beigloo, Younes Nazari, Puyan Hoseinpur, Meysam Goudarzi, Ghasem Bakhshanddeh**. Corporate Governance: Strategic Role of Board of Directors and Its Effect on Financial Performance Case Study: Auto Companies Listed in Tehran Stock Exchange**. *J Am Sci* 2013;9(7):207-214]. (ISSN: 1545-1003). http://www.jofamericanscience.org. 25

Keywords: Corporate Governance, Auto Industry, Board of Directors, Strategic Management, Corporate Financial Performance

Introduction

Private stock companies who actively participate in country economy are developed form of personal ownership. Personal ownership in companies goes through several transformations during its development process and moves toward its ultimate destiny to form public stock companies. Public stock companies are able to attract huge volumes of resources to manage large scale production of goods and services. These companies play important roles in economy (Rahman Seresht and Mazlomi, 2005).

Stock companies separate management from ownership. Managers act as representatives of shareholders and direct their respective companies on behalf of shareholders. This representative relation between managers and shareholders may create conflict of interests. This conflict of interest is referred to as representation problem and occurs when managers make decisions that are against shareholders' interest (Karni, 2007).

Shareholders elect board of directors to act as their representatives to supervise and control corporate management. The relationship between board of directors and management is defined within corporate governance. Corporate governance may have been initially devised to supervise companies in the direction that maximizes shareholders' interest. However, the current view of corporate governance focuses on the interest of stakeholders and society as a whole (Clark, 2007).

Board of directors is a critical part of the internal mechanism of corporate governance. Board members supervise management actions and provide consultation to managers in the development of strategic planning and its implementation. Board of directors plays critical roles in corporate governance guidelines (Shariat Panahi, 2001).

Shareholders have lost control of corporations as economy expanded and business enterprises grew larger. The ownership structures of companies have changed and a large number of shareholders have become minority shareholders. Only a few shareholders may participate in selection of board members and corporate executives.

Shareholder-management relation becomes further obscured when shareholders' primary interest is short term financial gains as opposed to long term control of company. Such situation puts corporate management and governance under complete control of company executives without an effective control. Top executives take charge of company operation with chief executive having the highest responsibility.

Corporate success depends on effective management. Big name companies owe their long standing positions to effective and efficient board of directors and corporate executives. Board of directors is at the heart of corporations. Board members should stay alert and receive with the required information if they are to function well (Hasas Yegane and Baghvemian, 2006).

Research Literature

Corporate governance is defined as a structure that represents the interrelationship and responsibilities of the main corporate groups including shareholders, board members, corporate executives, and other stakeholders. Corporate governance has all the required criteria and mechanisms to supervise, control, and improve corporate performance in the direction of achieving company objectives. Corporate governance has four main objectives, namely, responsibility, clarity, justice, and fairness. These objectives are to observe and support the rights of stakeholders (Hasas Yegane and Baghvemian, 2006).

Organization for Economic Cooperation and Development (OECD) has defined corporate governance as a collection of interrelationship among corporate executive, board members, shareholders, and other stakeholders. International Federation of Accountants defines corporate governance as responsibilities and approaches used by board of directors and corporate executives with the objective to identify the strategic paths that can help an enterprise in achieving corporate objectives, controlling risks, and responsive utilization of resources (Hasas Yegane and Kazemi, 2007).

Many models have been proposed for corporate governance. Models that are based on internal organization or external organization are the most favorite.

Internal Organization Model: In this model, a few shareholders manage and control corporation. Separation of shareholders from management is difficult. The problem of representation is minimal in this model as company is under control of shareholders. This model mostly exists in Eastern Europe and Asia.

External Organization Model: This model exists in countries that have market economy. Corporations are owned by a large number of shareholders and there is a separation of ownership and management. This model is prevalent in United States and England. Banks (2004) offered the following characterizations for internal and external corporate governance (cited in Hassas Yeganeh and Baghoomian, 2006).

Internal Organization Corporate Governance:

1. Board of Directors: Selection and appointment of strong and neutral board of directors.
2. Executive Management: Division of responsibilities among executive managers.
3. Non-executive Management: Forming board committees from independent and non-executive managers.
4. Internal Controls: Design, development, and implementation of suitable internal control systems.
5. Organizational Ethics: Development and promotion of professional mannerism and organizational ethics.

External Organization Corporate Governance

6-Legal Supervision: Provide proper legal system

7-Capital Market Efficiency: Capital market development and strengthening its efficiency

8-Major Shareholder Supervision: Motivating shareholders to purchase major controlling stake.

9-Minority Shareholder Supervision: Respecting the rights of minority shareholders and allowing their participation in corporate activities.

10-Institutional Investors: Promotion and development of institutional investment

11-Ranking Institution: Facilitate activities of ranking institutions.

Suitable corporate governance shall have the following specifications (Mokarrami, 2006):

12-Provide required incentives for board of directors and executive management to encourage them to work for the financial interest of company and shareholders.

13-Facilitate effective and efficient supervision.

14-Encourage optimum utilization of corporate resources.

Effective corporate governance has macro and micro level requirements.

Macro Level Requirements: companies should endeavor to achieve their objectives. A company should increase shareholders equity from investors' perspective. Corporate governance could act as a mechanism to examine whether strategic decisions are made with the intention to increase shareholders value. Management responsibility requires taking risks in order to maximize shareholder value without passing any risk to shareholders (Keasey and Wright, 1993). When corporate objectives change to address the interest of other stakeholders such as employees and creditors, only objectives are changed but the required mechanisms remain unchanged (Ra'eesi, 2008).

Micro Level Requirements: Allen Greenspan defined corporate governance as optimum and effective allocation of financial resources; therefore, the secured resources through credit or investment should be directed toward activities that have the highest return. Recent WorldCom and Enron failure experiences in United States proves this fact that non-optimum allocation of resources in short term will have long term consequences resulting from the damages to public trust (Keasey, et al, 2005).

Strategy is simply defined as adoption of organization to its environment (Rahmanseresht, 2005). Hunger and wheelen defined three elements for strategic management, namely, development, implementation, and control. According to this model, macro view of corporate governance can be thought of as participation of board of directors in the development of strategy and micro view of corporate governance can be thought of participation of board of directors in implementation of strategy. This study adapted the former view in its research approach.

Research Background

William, et al (1992) in a research about participation of board of directors in strategic decision making discovered that it depended on the reaction of board of directors to institutional pressures and external strategic adoption. They interviewed 114 board members to collect the required data for their study. Data analysis revealed that the directors' participation in strategic decision making was negatively related to number of board members and their combination and positively related to the age of organization. Therefore, it is possible to conclude that participation of board of directors in strategic decision making is directly related to corporate financial performance.

Zahra and Pearce (1992) studied the combination of board of directors from strategic point of view. They examined the relation between combination of board of directors versus past performance, corporate strategies, and expected future financial performance. Study sample included 119 industrial corporations from Fortune 500 for the period from 1983 to 1989. They used non-executive board members as indicator of boards' combination. They used rate of return on assets, rate of return on shareholder equity, and dividend per share as indicators of corporate financial performance. Study analysis revealed significant positive relation between board member combination and corporate financial performance.

Millstone and McAvory (1998) studied the effect of active board of directors on corporate performance in large enterprises. They analyzed the economic information on 154 large enterprises for a period from 1991 to 1995. They discovered a direct relation between active board of directors and corporate financial performance.

In a research about participation of board of directors in strategic decision making, Pugliese and Wenstop (2007) examined the real commitment on the part of board members for exercising their strategic role. Their research model focused on board activities and its view of quality. They considered these two factors to be more important than board make up, number of directors, membership of chief executive, and the ratio of executive and non-executive board members. After testing study hypotheses on Norwegian companies, researchers concluded that board activities and its perception of quality have higher contribution on increasing board's participation in strategic management than board member make up.

Judge and Zeithaml (1992) believed that the role of board of directors in strategic management is related to corporate financial performance. They examined the effect by evaluating certain controlling variables including industry type and number of board members. They believed that board of directors helped top management to avoid mistakes by providing regular consultation and assistance.

Board Responsibilities and Strategic Management

Board of directors may influence organizational strategies in two ways. Indirect effect on strategic decisions is through activities such as evaluation of decisions made by top management, regular reviews of corporate performance, revisions of strategic plans, and supervision of strategy implementation (Feigner, 2005). Board of directors directly affects corporate strategy through approval of strategic plan, request for investigation about important issues, and assistance in strategy development and evaluation (Judge and Zeithaml, 1992).

Hunger and Wheelen (2007) defined three strategic responsibilities for board of directors.

1. Supervision: Board of directors can oversee internal and external developments through its committees. They can point out the changes that corporate executives may have overlooked. This is the minimum requirement of the board.
2. Evaluation: Board of directors can review plans, decisions, and action of corporate executives. They may agree or disagree with them, make recommendations or suggestions, and devise

alternatives. A more active board undertakes evaluation in addition to supervision.

3. Initiate Actions: Board of directors can make assignments and decide strategies for corporate executives. Only the most active board of directors undertakes this task in addition to the previous two (Hunger and Wheelen, 2007).

Generally, board of directors is responsible for development of mission, perspective, and values, also for identification of strategic activities, as well as, seeking for a suitable environment for creating opportunities (Hendry and Kiel, 2004, p. 511)

Daily, et al (2003) and Zahra and Pearce (1989) considered three critical roles for board of directors, namely, service, supervision and control, plus strategic roles.

***A.* Service responsibility**

Board of directors provides consulting and information to top management. Board provides these services when they have limited participation in corporate activities; employing resources is fully vested in top management; and gaining advantage in resource procurement depends on company recognition and experience. Service responsibilities can be performed in following ways:

1-Elevating company recognition and prestige
2-Partnership with other companies
3-Assisting in search for scarce resources
4-Acting as company envoy
5-Consulting to top management.

***B.* Supervision and Control**

Board of directors performs supervision and control by selection of top executives, determining their compensations, evaluating top executives, assessing company performance, and finding ways to maximize shareholders' equity (Adams, et al, 2010). Board's responsibility may be summarized into risk management and preserving shareholders' equity. Supervision and control may include 10 tasks.

1-Assurance about company survival (preserving shareholders' interests)
2-Adjusting corporate risk
3-Employment, evaluation, and dismissal of general manager
4-Defining management authority
5-Supervision and evaluation of management
6-Operational control
7-Reporting and communication with shareholders
8-Dividend proposal
9-Evaluating board of directors performance and planning for board meetings
10-Reviewing social responsibilities.

***C.* Strategic Role**

Strategic responsibilities of board of directors include development of company mission and strategies, plus implementation and evaluation of strategy (Ong and Won, 2008). Strategic responsibilities include four tasks:

1-Development and revision of company mission: What is our business?
2-Access supervision (gate keeping): active evaluation and revision of strategic proposals
3-Confidence building: encourage managers to record and file own activities geared toward strategic objectives.
4-Selection of executive director: selection of a successful individual who is acceptable to others.

Corporate Governance Models

A. Hunger-Wheelen Model

According to this model, board of directors engage in strategic management by providing services, performing supervision and control, plus participating in strategic planning. Table 1 shows the degree of board of participation in strategic management. Participation of board members may vary from minuscule to very active. Low participation of board members is depicted on the left of the range in table 1. The low range of participation is represented by phantom and rubberstamp. They represent the board members who never participate in development of strategies unless company faces crisis situation. This model assumes the following roles for board of directors.

1. Catalyst: Board of directors takes a leading role in design and adjustment of mission, objectives, strategies, and policies.
2. Active participation: Board of directors comments on mission, strategies, and policies or accepts them.
3. Nominal participation: Board of directors has limited participation in performance evaluation or review of key selected decisions, indexes, or plans.
4. Minimal review: Board of directors officially reviews certain issues or activities.
5. Rubberstamp: Board of directors delegates all management decision makings and approves any decision they make.
6. Phantom: Board of directors is unaware of what is going on and even if they do, they do not take any action.

Table 1: Board's Participation in Strategic Management (Hunger and Wheelen, 2009)

Phantom	Rubberstamp	Minimal Review	Nominal Participation	Active Participation	Catalyst
Never is aware of what needs to be done, and doesn't do anything even when is aware	Delegates decision making to top management then, approves whatever decision they make	Formal review of selected issues or activities	Limited participation in performance evaluation or review of selected key decisions. Identification of indexes and management programs.	Either accepts corporate mission, strategies, and policies or comments on them.	Leading role in development and adjustment of corporate mission, objectives, strategies, and policies. Board of directors has its own strategy.

B. Nadler Model

Nadler model examines board of directors' participation in strategic management based on five roles (Table 2).

1. Passive board: This is the traditional form of board of directors with limited participation and action. Board of directors acts according to general manager's preferences. They have limited authorities and their main responsibility is to approve general manager's decisions.
2. Certifying board: This model emphasizes on an external general manager who is acceptable to shareholders. Board of directors certifies that business is being managed properly and general manager is acting according to regulations.
3. Engaged board: Board of directors is acting as a partner to general manager. Board of directors provides insight, consulting, and support for key decisions. Board of directors supervises general manager and corporate performance. It actively defines roles and limits of management positions.
4. Intervening board: This model of board of directors is for crises where it deeply engages in main decision makings by participating in consecutive and long meetings.

1. Operating board: This model of board of directors actively make key decisions and announces them to top management for implementation. This model is useful when general manager is inexperienced.

Organizational Performance

Accounting, financial, and economic measurements of corporate performance have limitations and weaknesses. This study uses Tobin's Q to evaluate financial performance of companies under study. Tobin's Q is defined as the ratio of market value divided by value of corporate assets. It is an index to evaluate corporate performance. This index was proposed by James Tobin in 1978. His intention was to provide a cause and affect relationship between Q index and corporate investment. When index is larger than one, there is a large incentive for investment in the company - high Q usually represents that company has high growth potential. There is no incentive to invest when Q index is less than 1.

Table 2: Board of Directors' Participation Minimum Participation Maximum Participation (Nadler, 2004)

Passive Board of Directors	**Approving Board of Directors**	**Committed Board of Directors**	**Intervening Board of Directors**	**Active Board of Directors**
Working along with general manager and according to his preferences	Assuring shareholders that general manager is working conforming to board of directors wishes	Providing insight, advice and recommendation in support of general manger and management team	High participation in making key decisions	Making key decisions for general manager to implement them
Highly limited participation and activity	Emphasis on the independence of board of directors calling board meetings without general manage	Leaving general manager fully responsible for corporate supervision and performance providing only guidance and judgment	Arranging consecutive board meetings , frequent sessions, and often making short announcements	Filling the experience gap for an inexperienced general manager
Least responsive	Being aware of current performance and selection of an external board of directors for evaluating general manager	Mutual and beneficial dialogue for making key organizational decisions		
Approving management priorities	Establishing regular and consecutive processes	Seeking for proper financial and industrial skills for increasing value		
	Shareholders accept the willingness to change corporate management	Spending time to define required roles and actions for board of directors, determine limits for general manager, and define board of directors' responsibilities		

Research Methodology

This study examines the role of board of directors in strategic management and evaluates its effect on performance of companies active in auto industry. It used the information obtained from auto companies listed in Tehran Stock Exchange in order to determine the relationship between the roles of board of directors in strategic management versus corporate financial performance. This data is generalized to determine the factors that are effective in success of active companies in auto industry.

Statistical population included all board members of companies listed in Tehran Stock Exchange under auto industry in October 2011. Study sample included 105 board members selected from the statistical population. Data collection tool was a 19-item questionnaire. This questionnaire was distributed to the selected board members. 78 recipients responded, of which 75 questionnaire were accepted. Financial information was taken from a CD obtained from Iran National Stock Exchange Organization. The time period for this study was December 2011 and January 2012. Questionnaire reliability was confirmed by expert opinion. Questionnaire consistency reliability was confirmed by calculation of Cronbach alpha (α=0.707).

Study Hypotheses

This study had six hypotheses:

1. Catalyst role of board of directors in strategic management is significantly related to corporate financial performance.
2. Active participation role of board of directors in strategic management is significantly related to corporate financial performance.
3. Nominal participation role of board of directors in strategic management is significantly related to corporate financial performance.

- Minimal review role of board of directors in strategic management is significantly related to corporate financial performance.
- Rubberstamp role of board of directors in strategic management is significantly related to corporate financial performance.
- Phantom role of board of directors in strategic management is significantly related to corporate financial performance.

Study Variables

A. Independent variables

4. Catalyst role of board of directors
1.1 Mission development and adjustment process
1.2 Objective development and adjustment process
1.3 Strategy development and adjustment process
1.4 Policy development and adjustment process
1-Active participation role of board of directors
1.5Making recommendation on corporate mission
1.2Making recommendation on corporate strategy
1.3Making recommendation on corporate policy
2-Nominal review role of board of directors
2.1-Participation in making key decisions
2.2-Participation in reviewing management programs
2.3-Emphasis on arranging board meetings
4-Minimal review role of board of directors
4.1-Formal review of some selected strategic issues or actions
4.2-Final responsibility of corporate performance
4.3-Staying informed about management functions and responsibilities
5-Rubberstamp role of board of directors
5.1-Limited functions and responsibilities
5.2-Delegation of authority for making strategic decisions top corporate executives
5.3-Approval of most decisions made by corporate executives
6-Phantom role of board of directors
6.1Staying informed about corporate strategy
6.2-Non-interference in corporate strategy
6.3-Limited authority for undertaking corporate activities

B. Dependent variables

- Corporate financial performance as measured by simple Tobin's Q

Conceptual Framework

This study considered Hunger-Wheelen (2009) and Nadler (2004) models for development of its own framework. In this framework, board of directors participates in strategic management and therefore, affects corporate financial performance. The main reason for selection of Hunger-Wheelen model as the base for this study was its conformance to strategic decision making within planning process.

Research Findings

Data analysis shows that there is a strong relation between catalyst role of board of directors and corporate financial performance. This relation indicates that exercising corporate governance on top management through internal mechanism of board of directors has a very strong effect on corporate financial performance in auto companies. This can be interpreted as those companies whose board of directors participates in development and revision of mission, strategy, policies, and objectives have better corporate financial performance compared to other companies.

There is a middle range relationship between active participation role of board members in company activities and corporate financial performance. In other word, boards of directors who actively participate in development of company strategy, mission, and policies have middle range effect on corporate financial performance.

Boards of directors who have nominal participation in organizational activities produce poor effect on corporate financial performance. In other words, boards of directors who take part in selected key decisions and certain management programs and attend board meetings, have a poor effect on corporate financial performance.

Boards of directors with minimal review, rubberstamp, or phantom roles had poor inverse, middle inverse, and middle inverse effects on corporate financial performance, respectively. In other words, improper board member activity leads to declined corporate financial performance. Table 3 summarizes the study findings.

Figure 1 Board of Directors' Participation versus Corporate Financial Performance

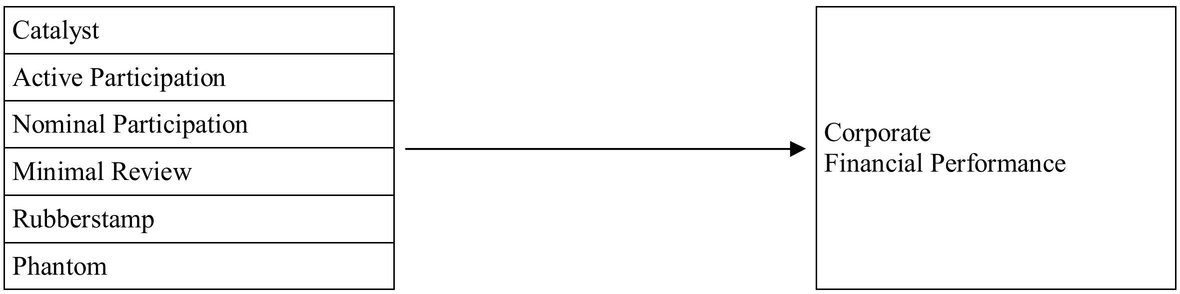

Table 3: Study Finding Summery

Hypothesis	Dependent Variable	Independent Variable	Significant Level	Pearson Correlation	Type of Relation	Intensity of Effects	Result
1	Financial Performance	Catalyst	0.000	0.758	Direct	Strong	Confirmed
2	Financial Performance	Active participation	0.000	0.504	Direct	Medium	Confirmed
3	Financial Performance	Nominal participation	0.010	0.279	Direct	Poor	Confirmed
4	Financial Performance	Minimal review	0.045	-0.299	Inverse	Poor	Confirmed
5	Financial Performance	Rubberstamp	0.000	-0.531	Inverse	Medium	Confirmed
6	Financial Performance	Phantom	0.000	-0.550	Inverse	Medium	Confirmed

Based on the findings of this study, it is recommended that board of directors in auto industry should maintain high levels of participation in strategic management. This participation gains more importance especially when one considers the many challenges auto companies are facing today because of myriad problems. Effective participation of board members in various corporate functions especially strategic management could contribute to success of auto companies.

Auto industry challenges increases the critical role board of directors can play in corporate performance. Monitoring changes in market and economy in order to make proper decisions based on the speed and severity of changes shall undoubtedly have profound impacts on long term success of active enterprises in auto industry.

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5/22/2013