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Corporate Governance Effects of Strategy-making Process

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ABSTRACT

In strategic management theory, corporate strategy process is composed of strategy formulation and strategy implementation. In this process, strategy formulation is the focus of corporate strategy decision-making. In traditional literature on strategy formulation, the main perspective was the participants and the rational behavior in strategy-making process. As a result, the diverse scenarios in strategy-making process were examined, the different types of strategy formulation were defined and the performance improvement associated with successful strategy-making process was explored. In this paper, we adopt governance perspective of strategy, analyzing the process of strategy formulation, arguing that corporate strategy-making process can play a governance effect. We believe, it is the change from individual rationality to organizational rationality brought about by governance effects that enables companies to improve performance. These provide a supplement to traditional strategy-making theory.

1 Introduction

Since the 1960s, as strategic concept was introduced from military area to business area (Chandler, 1962; Ansoff, 1965), corporate strategy has gradually become an important issue in the organizational theory and practice. As to company's strategic process, Andrews (1971) divided it into two stages, i.e. strategy formulation and strategy implementation. It is generally believed that strategy formulation is the early stage of strategic process, focusing on decision-making; and that strategy implementation is the later stage, with more emphasis on guarantee and control; and that both of them promote each other and evolve together (Andrews, 1971; Mintzberg and Waters, 1985). In this paper, we focus on decision-making, so we choose the process of strategy formulation as our research object.

For a long time, when people were discussing corporate strategy, they were more likely concerned with how the *organization* could fit with the external environment in order to achieve organizational performance (Chandler, 1962; Ansoff, 1965; Porter, 1996). The "organization" mentioned above, is seen as a whole, which implies an assumption that a company as an entity has a common profit goal. For example, through examining the prior literature, Hart (1992) brought forward an integrated framework of strategy-making process. He thought that strategy-making meant some rationality or what Simon (1957) proposed *bounded rationality*. Undoubtedly, such rationality refers to organizational rationality, i.e. the rationality embodied in strategy-making process is to achieve long-term organizational performance. However, in the most prior literature, as a company was a legal person, corporate strategy could not be

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formulated automatically. So, strategy-making requires the involvement of various stakeholders, including managers, board of Directors, employees, and even shareholders (Hart, 1992; Papadakis et al., 1998). According to principal-agent theory (Jensen and Meckling, 1976), the goals of the participants mentioned above are not entirely consistent; while corporate governance is an institutional arrangement to coordinate the interests of all types of capital investors in enterprises (Williamson, 1988; LI Wei'an, 2001); if the result of strategy-making process can reflect organizational rationality, the goals of those participants have undoubtedly been coordinated to some extent, thus, the governance effect throughout the process is surely worth discussing.

2 Relevant Literature Review

For the issue of strategy formulation, prior literature take three main perspectives: first, the role that the participants play in strategy-making process; second, the purpose and scenarios of strategy-making process; third, the relationship between strategy-making process and corporate performance.

2.1 Literature on strategy formulation

The primary participant of strategy-making process is the manager (or CEO), as to this, Gioia and Chittipeddi (1991) believed that CEO had the primary responsibility in determining the strategic direction and plans; Papadakis et al. (1998) also pointed out, CEO could exert significant influence in strategic decision-making process. More literature first recognize the role CEOs play in corporate strategy-making process, and then explore how the Board is involved in strategy-making process. For instance, Westphal and Fredircks (2001) explained the impact the Board of Directors has on corporate strategy in two ways; Forbes and Milliken (1999) also argued that both the inside directors and outside directors should take public responsibility in strategy-making process. As far as employees were concerned, Nonaka (1988) thought that strategy-making process needed senior leadership, and was also inseparable from the followers including all members of the organization; Hart's literature review (1992) found that employees' involvement could make a difference in strategy formulation. As to shareholders, Judge Jr. and Zeithaml (1992) regarded the involvement of the Board in strategy-making process as either an institutional response or a strategic adaptation to external pressures; we think these external pressures are undoubtedly mainly from shareholders. In short, we find that almost all parties in corporate governance structure are involved in strategy formulation.

The purpose and scenarios of strategy-making process are not all the same, Mintzberg and Waters (1985) explored strategy and strategy-making under eight different conditions; Shrivastava and Grant (1985) studied 32 Indian companies on strategic decision-making process, and proposed four strategic decision-making models; Hart (1992) analyzed the roles that executives and employees played respectively, and presented five types of strategy-making process. In addition, as a decision-making process, strategy formulation necessarily implies rationality or bounded rationality (Hart, 1992). For example, Fahey (1981) pointed out that strategic decision-making emerged as a complex, multi-organizational level phenomenon, which must contain rationality or the appearance of rationality; Hitt and Tyler (1991) believed that though rational processes might dominate the strategy formulation process, industry and executive characteristics might also affect the decision process; while, Eisenhardt and Zbaracki (1992) made a conclusion that strategic decision-making was an interweaving of both bounded rationality and political processes. In this regard, we have to ask a question that whose rationality the so-called rationality is, since according to corporate governance theory, shareholders' rationality are not equal to the managers', and not equal to the employees' either. For example, sometimes diversification strategy does not satisfy shareholders, sometimes due to the diversification discount (Lang and Stulz, 1994), but to managers, it is rational (Amihud and Lev, 1981). Faced with this question, we think we need to view strategy formulation from the corporate governance perspective.

As to the relationship between strategy-making process and corporate performance in different situations, Judge Jr. and Zeithaml (1992) found that board involvement to be positively related to financial performance after controlling for industry and size effects; Hart and Banbury (1994) proved through empirical evidence that the more complex the strategy-making process (thoughtful consideration), the better the corporate performance. In response, we think that if corporate governance mechanism can play a full role in strategy-making process, then this process will be more complex, the performance will be even better, which is a manifestation of governance effect.

2.2 Literature on corporate governance

It is mainly Williamson's contribution (Williamson, 1985, 1986, 1998, 1999) to study strategy from the governance perspective. This perspective stems from Ronald Coase's classic article on "The Nature of the Firm" (1937) and his later article on "The Problem of Social Cost" (1960), which look at strategic issues mainly from the transaction cost perspective. Williamson (1999) pointed out, transaction cost economics could affect strategy through six key moves, the first is human actors; because of people's self-interest, the opportunism which manifests itself as moral hazard and adverse selection would exist in the behavior of participants in corporate strategy. According to Williamson, we believe that it must give full play to governance effects in order to eliminate opportunism in the process of strategy formulation.

In addition, Baysinger and Hoskisson (1990) argued that the Board of Directors provided governance guarantees to both equity capital and manager employment contract in large corporations; therefore, if the Board of Directors could play an important role in corporate strategy-making process, the interest conflict between shareholders and the manager would be coordinated. For this reason, in the previous review of prior literature, we find that in lots of literature, the Board is regarded as an important participant, which would not be repeated here.

3 Governance Effect in the Process of Strategy Formulation

Corporate strategy-making process is a process of organizational rationality, but we believe that it is only an outward manifestation of strategy formulation. If the corporate governance perspective is to be adopted to analyze this process, we shall find, the rationality which appears in strategy formulation is actually a result of coordination among various capital investors. Strategy-making process provides corporate governance a stage to work; furthermore, it undoubtedly has governance effect. In order to demonstrate this effect, we make a number of propositions below.

Proposition 1: Strategy-making process and its disclosure help shareholders to know the company's business situation, reducing their information search cost; and the pressure from shareholders will make the result of corporate strategy-making closer to shareholders' objective, therefore reduce their residual loss.

In a company, shareholders are investors of physical capital and the company's owner. The "Company Law" has stipulated that shareholders have the supreme power in a company. Because of the complexity of management tasks, the decentralization of ownership, and the possible behavior of free-riding, shareholders are not involved in the specific management of a company (Berle and Means, 1968). As the principal in a company's most important principal-agent relationship, shareholders give the operation right to the manager, only retain the right of residual claim; furthermore, to ensure residual income, shareholders also retain the ultimate power of decision-making, which includes appointing and removing the management team in the end (Alchian and Demsetz, 1972). In addition, as a fund provider of corporate finance, potential shareholders have the right to different investment options.

Shareholders need to effectively monitor managers, for which, sufficient information is required. Investment options for potential shareholders also need adequate information. Information search costs are the most important transaction costs (Williamson, 1981). Corporate strategy-making, as a major decision, must be disclosed to shareholders, so the process of strategy-making will become the channel through which shareholders understand the company's operation situation. Shareholders can determine whether the result of corporate strategy formulation is consistent with their own interests, and can also judge the managers' performance through comparing the result of the strategy implementation to the previous strategy formulation, so that they are able to make decisions (dismissing managers or voting with their feet). Potential shareholders can also take investment options on the basis of different strategy formulated by different companies. The decisions and options mentioned above will no doubt reduce the cost of information search taken by shareholders. At the same time, these decisions and options made by shareholders will bring pressure to the specific persons (especially the CEO) who take part in the process of strategy-making, which will let the result of corporate strategy-making be close to shareholders' objective. Since the objective of strategy-making becomes more consistent with shareholders', the residual loss (part of agency costs) proposed by Jensen and Meckling (1976) will be reduced.

Proposition 2: The participation of the Board of Directors in strategy formulation will contribute to checks and balances among corporate governance structure and scientific decision-making.

The Board controls the supreme decision-making power (Fama and Jensen, 1983), and directors are elected by the shareholders. With the improvement of independent-director system, the Board represents not only the interests of shareholders, but also the interests of other stakeholders. There are two reasons to the Board's involvement in strategy formulation: one is required by the institution of Board of Directors itself; the other is under the external pressure (Judge, Jr. and Zeithaml, 1992). The intention and power of the Board of Directors have a major impact on corporate strategy-making (Golden and Zajac, 2001), which to some extent restricts CEO's unique influence on strategy-making. Since the directors' sources are quite rich, specifically, outside directors can judge independently when participating in strategy formulation, it is easier for a company to achieve scientific decision-making. Just for this reason, studies have found that board involvement in strategy-making process shows positive relationship to financial performance (Judge, Jr. and Zeithaml, 1992).

Proposition 3: Appointing a director with strategic knowledge and skill will give the manager better supervision and advice in the strategy-making process.

As a member of the Board, the director has the right to vote when the Board makes decisions. The background of directors will affect how the Board plays the role of corporate governance. The director with strategic knowledge and perspective will be more willing to participate in strategy-making process (Carpenter and Westphal, 2001); Active directors who have relevant knowledge and skills will also provide better supervision and advice when they are involved in strategy-making process. In fact, the director with strategic background can not only play a due role in strategy-making process, but also has a major impact on corporate governance (Carpenter and Westphal, 2001).

Proposition 4: Strategy-making process will help to reduce manager's moral hazard.

In modern companies, ownership and control are separated; on this basis, managers control the right of management with their professional skills and fiduciary duty, and even master part of the residual rights of control. The agency problem between shareholders and managers is one of the main elements of corporate governance (Berle and Means, 1968). In the strategy-making process, managers assume important responsibilities (Gioia and Chittipeddi, 1991). Because there are other participants such as the Board and employees, along with shareholders' pressure from outside to inside, the manager is not easy when making strategic decisions. In order to eliminate conflicts and achieve strategic consensus, Strategy-making process has become a process of compromise, in which, managers, the Board, employees and shareholders pursue the same interests as much as possible. Knight et al. (1999) showed in their research that the diversity of top management team had negative effects on strategic consensus. So, in strategy-making process, the manager whose objective is of big difference from that of the Board, employees and shareholders will gradually leave the company, either to resign or to be dismissed. Shareholders will probably also experience similar process--part of shareholders vote with their feet, and part of new shareholders who can accept the process of strategy-making make investment to enter the company. Ultimately, through the process of strategy-making, the objective functions between all shareholders and managers tend to converge, therefore, it achieves incentive compatibility as much as possible and the agency problem between shareholders and managers is eased. The strategy formulated by the main responsibility of managers themselves, even if with some compromise, is mainly consistent with managers' objective, therefore, the moral hazard will occur rarely.

Proposition 5: Strategy-making process will encourage employees to play a role in corporate governance.

Employees are performers of specific matters in the company, and also close stakeholders of the company. Employees get monetary compensation from the company, and their social security is also closely related with the company after retirement. As employees know the specific information of the company, corporate strategy cannot be made without the participation of employees. Even in certain scenarios, the process of corporate strategy-making is bottomed up (Nonaka, 1988; Hart, 1992). This process has two effects: first, as human capital providers, employees' interests can be protected to some extent, which is indeed one of the goals of corporate governance; second, this process can foster employees' sense of ownership, which will play a better role of bottom-up monitoring, and reduce the manager's moral hazard.

Proposition 6: The newly appointed manager of innovative spirit will help the company formulate a transformation strategy successfully.

If shareholders and the Board hope to implement strategic transformation, they will want it to be promoted by the new manager. New top management, especially the new top management from outside, usually advocate change, determines new strategic direction; furthermore, in the process of hiring a new manager, the Board's preferences are important (Westphal and Fredricks, 2001). In order to make transformation strategy successfully, the company need entrepreneurial strategy, thus innovative managers are essential (Murray, 1984). Under the promotion of the new innovative manager, the company's business area, business model and business philosophy may all change a lot, and this is called strategic transformation (Levy and Merry, 1986). After that, corporate governance may also have major changes.

In summary, strategy-making process implies governance effects. Hart and Banbury (1994) showed that the more complex the strategy-making process, the better the corporate performance; to this, their explanation was that the complex process could avoid blind spots, and consider problems more thoughtfully, thus improve performance. In this regard, we explain that under the governance effect of strategy formulation, the rationality of strategy formulation changes from individual rationality to organizational rationality, thereby improving performance.

4 Conclusion and Discussion

Most of the prior literatures on strategy-making process focus on the participants of strategy formulation, the purpose and scenarios of strategy-making process and the performance of strategy formulation. It is believed in these papers that corporate strategy-making implies rational factors, so successful strategy formulation can improve corporate performance. However, this explanation does not seem complete. If we follow Williamson's governance perspective to analyze strategy formulation, we can find that the various participants in strategy-making process are actually part of the corporate governance structure, and that the organizational rationality embodied in the process of strategy-making is actually a compromise of individual rationality which is under the influence of corporate governance. Strategy-making process becomes a platform for corporate governance to function, and the process itself has governance effect too. Therefore, we follow this perspective to explore the governance effect of strategy formulation by the way of proposition proposed and demonstrated; the main conclusions are as follows:

Strategy-making process and its disclosure can reduce shareholders' information search cost and help them to know the company's business situation; the pressure from shareholder will let the corporate strategy-making process be closer to shareholders' objective, therefore reduce shareholders' residual loss; the Board of Directors participating in strategy formulation can produce checks and balances among corporate governance structure and scientific decision-making; the appointment of the director with strategic knowledge and skill will help the Board provide better supervision and advice in the strategy-making process; in the strategy-making process, the compromise between shareholders' objective and managers' objective will help to reduce the manager's moral hazard; strategy-making process will include employees to play a role in corporate governance; the newly appointed manager of innovative spirit, will help the company formulate a transformation strategy successfully.

The findings above explain the reason why the strategy-making process can improve corporate performance from a perspective of governance effect, i.e. governance effect mainly change the individual rationality into organizational rationality, and the strategy-making process that reflects organizational rationality can improve performance, which is a supplement to traditional view. However, these conclusions are mainly derived from induction and deduction in theory; it still requires inspection and confirmation from the empirical results, which is the content of our future work.

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