

THE INFLUENCE OF THE BOARD OF DIRECTORS ON THE STRATEGIC RENEWAL BEHAVIOR OF LISTED CORPORATIONS

BOARD CONTROL AND BOARD COLLABORATION

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ABSTRACT

For a long period scholars and practitioners have recognized the dual nature of the role of the board of directors. On the one hand the board of directors has to be independent and distant in order to assure adequate control and monitoring of top management teams. On the other hand the board of directors has to be interdependent and involved in order to fulfill their strategy and/or service role. This confronts the board of directors with the challenge to balance the conflicting demands of board control and board collaboration. This paper presents a conceptual framework which elaborates on the influence of both board roles on strategic renewal processes within large corporations operating under the rules of the Dutch 'structure regime'.

Key words: corporate governance, board roles, board control and board collaboration, and strategic renewal

I. INTRODUCTION

During the last decade, the attention for corporate governance has rapidly increased in the popular press and the scientific literature. Corporate scandals like Enron and WorldCom in the United States, Parmalat in Italy, and Ahold in the Netherlands have heated the international corporate governance debate [Ingley and Van der Walt, 2005; Jonsson, 2005, Kiel and Nicholson, 2003]. One of the issues in the corporate governance debate is centered around the nature and division of responsibilities between the board of directors and the management board. Agency theorists have emphasized the merits of independent control carried out by the board of directors in order to establish a clear division between decision-management and decision-control [Davis et al., 1997; Fama and Jensen, 1983]. However, the stewardship and resource-dependency theories challenge the rational economic assumptions underlying the agency theory and state that active involvement of the board of directors in decision-management may actually be beneficial for corporations [Davis et al., 1997; Muth and Donaldson, 1997; Pfeffer, 1972; 1973]. Recent evidence suggests that boards of directors indeed perceive their decision-management contributions to be highly important [Heracleous, 2001; Ingley and Van der Walt, 2005, Stiles, 2001], and they are increasingly becoming more actively involved in decision-management [Hendry and Kiel, 2004; McNulty and Pettigrew, 1999; Westphal et al., 2001]. Therefore, boards of directors face the challenge of balancing the conflicting requirements of board control, which requires independence and distance, and board collaboration, which requires interdependence and closeness [Demb and Neubauer, 1992; Fiegener, 2005, Huse, 1994; Sundaramurthy and Lewis, 2003].

However, there is limited conceptual and empirical evidence that attempts to relate the implementation of both board roles to the strategic renewal behavior of corporations, which is a direct outcome of the corporate strategic decision making process [Goodstein et al., 1994; McDonald and Westphal, 2003; Golden and Zajac, 2001]. Boards of directors will be involved in these decision making processes, because of their legal responsibility for the overall corporate direction

[Goodstein and Boeker, 1991], because of institutional forces increasingly pressing for increased levels of involvement in decision-management, and because of the increasing convergence between the traditional decision-control role of the board of directors and the decision-management role of the management board [Maassen and Van den Bosch, 1999; Sundaramurthy and Lewis, 2003]. Prior research shows that both board roles indeed affect the strategic renewal behavior [Golden and Zajac, 2001] and financial performance of corporations [Westphal, 1999].

This paper contributes to the corporate governance literature in several ways. *Firstly*, the processes through which boards of directors affect the corporate performance are not well understood and empirically tested [Daily et al., 2003; Forbes and Milliken, 1999; Pettigrew, 1992; Stiles, 2001]. By focusing on the relationship between both board roles, and the strategic renewal behavior, and by presenting a conceptual framework with testable propositions, this research study addresses this issue. This process-oriented approach will enable us to 'better explain inconsistencies in past research on boards, to disentangle the contributions that multiple perspectives have to offer in explaining board dynamics, and to clarify the tradeoffs inherent in board design' [Forbes and Milliken, 1999:502]. *Secondly*, both board roles are rooted in different theoretical perspectives. By using multiple theoretical lenses, this study attempts to depart from the 'either/or-thinking' and argues that corporate value accrues from the simultaneous interplay between board control and board collaboration. *Thirdly*, international corporate governance reforms have, based on the assumptions of the agency theory, been focusing on the strengthening of the board independence. However, this strong emphasis on board structure and composition [form] may actually hamper the execution of the board collaboration role [processes] and have adverse corporate effects. By focusing on the board roles this study assists corporate governance reformers to think through the implications of policy reforms in a more balanced way.

The article is structured as follows. Firstly, both board roles and their inherent tensions are discussed. Secondly, the relation between both board roles, and the strategic renewal behavior of corporations is elaborated on. Thirdly, the impact of two moderators on the proposed relationship, the power of the board and the level of environmental uncertainty, are dealt with. Finally, the overall framework and avenues for future research discussed.

II. BOARD CONTROL AND BOARD COLLABORATION

The Dutch corporate governance code [2004:15] describes the role of the board of directors in the following way: 'to supervise the policies of the management board and the general affairs of the company and its affiliated enterprise, as well as to assist the management board by providing advice'. For a long period of time scholars have recognized this dual nature of the boards' responsibilities [e.g. Fiegner, 2005; Johnson et al., 1996; Zahra and Pearce, 1989; Pfeffer and Salancik, 1978; Westphal, 1999]. On the one hand, boards of directors have the legal responsibility to monitor and evaluate the management board in order to ensure that the management board is acting in the best interests of shareholders. This board role is rooted in the agency theory. This theory stresses the importance of board control in counteracting the possibilities of opportunism by management boards which arise as the result of the separation of corporate ownership and corporate management [Berle and Means, 1932; Davis et al., 1997]. By nominating, rewarding and/or firing executives, by approving and/or disapproving capital investments and audit reports, and by setting financial and strategic boundaries [Baysinger and Hoskisson, 1990; Johnson et al., 1996; McNulty and Pettigrew, 1999], the board is deemed to be one of the most important internal control elements [Daily et al., 2003; Fama and Jensen, 1983; Hendry and Kiel, 2004, Jensen, 1993]. To assure the exertion of adequate control, scholars and corporate governance reforms have stressed the independence of boards [Dalton et al., 1999; Rhoades et al., 2000; Westphal, 1999]. From this viewpoint adequate board control is mainly

characterized by the maintenance of distance, formality and a focus on the prevention of failures by executives [Hamel et al., 1998]. The Dutch corporate governance code [2004:17] explicitly incorporates this principle by stating that 'the composition of the supervisory board shall be such that the members are able to act critically and independently of one another and of the management board and any particular interests'.

On the other hand, boards of directors are responsible for the provision of advice and counsel to executives. As sources of intellectual and social capital [Carpenter and Westphal, 2001; Nicholson and Kiel, 2004], boards of directors may provide valuable organizational support by advising executives during strategic decision making processes [Johnson et al., 1996; McNulty and Pettigrew, 1999; Rindova, 1999; Stiles, 2001], and by providing access to strategic resources on which corporations are dependent [Boyd, 1990; Van Gulik et al., 2005; Pfeffer, 1972; 1973]. This role is rooted in the stewardship theory and resource dependency theory. The stewardship theory challenges the rational assumptions of the agency theory and asserts that executives are actually intrinsically motivated to act in the best interests of the corporation. Therefore, the role of the board of directors changes within this perspective from controlling and monitoring to facilitating and empowering [Davis et al., 1997]. The resource dependency theory states that corporations attempt to gain access to the resources on which they are dependent by incorporating elements, such as directors, of the corporation on which it is dependent [Pfeffer, 1972; 1973]. However, a prerequisite for the advice and counseling role and the provision of valuable resources is interdependence between the board of directors and the management board [Demb and Neubauer, 1992; Huse, 1994; Sundaramurthy and Lewis, 2003]. As a result, board collaboration is characterized by maintenance of closeness, informality, pro-activeness and a focus on joint value creation [Hamel et al., 1998]. This attitude is required in order to be able to fully utilize the stock of knowledge and skills which board members bring along [Forbes and Milliken, 1999; Wan and Ong, 2005]. Table 1 provides an overview

of the activity range, theoretical backgrounds, characteristics, and attributes of both board roles.

Insert Table 1

Both board responsibilities confront boards of directors with a paradox. On the one hand, they have to be independent to assure adequate monitoring and control. However, on the other hand they must be involved to be able to provide adequate advice and counsel to the management board [Demb and Neubauer, 1992; Fiegenger, 2005; Huse, 1994; Sundaramurthy and Lewis, 2003]. Previous studies have shown that both responsibilities indeed constitute two different elements of the board administration process [Gulati and Westphal, 1999; Westphal, 1999]. In Figure 1 the level of board involvement in the implementation of board control and board collaboration are set off against each other. This results in a matrix with four different quadrants of which each quadrant represents a different board role configuration. Firstly, managerial hegemony theory asserts that the board of directors in practice is completely dominated by the management board due to information asymmetry and the presence of inside directors. Therefore, these boards of directors do not actively carry out their control and collaboration roles [Quadrant C] and in fact merely act as rubber stamps of the management board [e.g. Hendry and Kiel, 2004; Kosnik, 1987; Pettigrew, 1992; Stiles, 2001]. Secondly, the agency theory emphasizes the control role of boards of directors which is required to assure that management boards are acting in the interests of the shareholders [Davis et al., 1997; Hendry and Kiel, 2004; Muth and Donaldson, 1997]. Board independence is deemed a necessity in this perspective in order to guarantee adequate monitoring. Therefore, these boards are characterized by high levels of board control and low levels of collaboration [Quadrant A]. Thirdly, the stewardship theory and the resource dependency theory emphasize the collaboration role of the board of

directors. By assuming that management boards are motivated to act in the best interests of shareholders by intrinsic means, this perspective stresses the value that accrues from utilizing the intellectual and social capital of board members [Davis et al., 1997; Muth and Donaldson, 1997]. However, active involvement is required in order to be able to utilize this potential. Therefore, these boards are characterized by high levels of board collaboration and low levels of control [Quadrant D]. Fourthly, instead of conceptualizing board control and collaboration as opposites on a continuum, scholars have begun to stress the merits of integrating both roles and the theoretical perspectives in which they are grounded [Daily et al., 2003; Fiegenger, 2005; Sundaramurthy and Lewis, 2003]. From this viewpoint boards are assumed to be able to integrate high levels of active control and collaboration without compromising the implementation of the individual board responsibilities [Quadrant B].

Insert Figure 1

The conceptualization of the paradox between board control and board collaboration by the boards of directors has important implications for the way in which they deal with it [Lewis, 2000]. Traditionally, board control and collaboration have been conceptualized as opposites on a continuum. This implies that boards have to make a trade-off between both responsibilities, because board control will undermine the stewardship of executives and the potential for board collaboration, while collaboration will undermine the execution of independent control [Sundaramurthy and Lewis, 2003]. This trade-off is observable in the tension between boxes A and D of the matrix [Figure 1]. Alternatively, scholars have stressed the value which accrues from maintaining and utilizing the potential of paradoxes by simultaneously managing its conflicting requirements [Lewis, 2000; Poole and Van de Ven, 1989]. Instead of being opposites, this line of thought defines the paradoxical forces as complementary,

non-substitutable and interrelated [Gibson and Birkinshaw, 2004; Lewis, 2000]. From this viewpoint, board control complements board collaboration by counteracting groupthink, while board collaboration simultaneously supports board control by counteracting the presence of distrust in the relationship between boards of directors and management boards [Sundaramurthy and Lewis, 2003]. The interconnectedness between both board responsibilities is associated with boxes B and C of the matrix [Figure 1]. By conceptualizing board control and board collaboration in this way, this study attempts to depart from the traditional 'either/or-thinking' [Lewis, 2000] and stresses the complementarity between both board roles. This results in the following proposition:

Proposition 1: *Board control and board collaboration complement each other.*

III. BOARD ROLES AND STRATEGIC RENEWAL

So far, the influence of board control and collaboration on the strategic renewal behavior of corporations has been left out of the discussion. Floyd and Lane [2000:155] define strategic renewal as 'the evolutionary process associated with promoting, accommodating, and utilizing new knowledge and innovative behavior in order to bring about change in the core competencies of the organization and change in its product market domain'. These strategic adaptations are necessary in order to be able to respond to environmental challenges or make use of market opportunities. They often have a large impact on the corporation, require large commitments to resources and are difficult to reverse [Grant, 2002]. Boards of directors will be involved in these strategic renewal processes, because they are legally responsible for the overall corporate direction [Goodstein and Boeker, 1991], and because institutional forces are increasingly pressing for heightened levels of board involvement in these processes [Judge and Zeithaml., 1992]. Recent evidence suggests that boards of directors indeed perceive their strategic contributions to be highly important [Heracleous, 2001; Ingley and Van der Walt, 2005; Stiles, 2001], and are becoming more actively involved in decision making processes [Hendry and Kiel,

2004; McNulty and Pettigrew, 1999; Westphal et al., 2001]. Table 2 provides an overview of eight studies which have investigated the relationship between the structure and behavior of boards of directors and the subsequent level of strategic renewal of corporations. Although decision-management is and remains the primary responsibility of management boards [Fama and Jensen, 1983], these previous studies reveal that boards of directors indeed influence strategic renewal processes within corporations.

Insert Table 2

This study proposes board control and board collaboration as two alternate, although complementary, elements of the board administration process [Gulati and Westphal, 1999; Westphal, 1999] through which boards of directors can influence the strategic renewal behavior of corporations. *Firstly*, active board control functions as a ‘corrective trigger’ for the initiation of strategic renewal in several ways. By monitoring whether the strategic and financial performance of the corporations are not falling behind the corporate aspiration levels [Baysinger and Hoskisson, 1990; Hendry and Kiel, 2004], by challenging the status quo and corporate decision making outcomes, by shaping and reinforcing an organizational context in which executives regularly have to think through corporate strategy [McNulty and Pettigrew, 1999], by setting boundaries and rewarding executives for strategic renewal actions, and by replacing dysfunctional executives [Goodstein and Boeker, 1991]. Previous studies have shown that the comprehensiveness of board control indeed positively affects the level of strategic change [Golden and Zajac, 2001], and the overall corporate performance [Westphal, 1999]. *Secondly*, active board collaboration acts as a ‘supportive trigger’ for the initiation of strategic renewal in several ways. As sources of external, requisite, and representative variety, board members can provide valuable advice and counsel to executives during sensemaking and

sensegiving processes [Rindova, 1999]. Furthermore, the network of interlocking directorates constitutes an important learning vehicle through which organizations can tap into the knowledge base of partner organizations [Mizruchi, 1996]. Past evidence reveals that these linkages influence decision making processes, like the adoption of board protection devices [Davis, 1991], the execution of mergers and acquisitions [Haunschild, 1993; 1994], and the implementation of strategic adjustments [Westphal et al., 2001]. Previous research has shown that the level of board collaboration indeed positively affects the level of strategic renewal [Golden and Zajac, 2001], and corporate performance [Judge and Zeithaml, 1992; Westphal, 1999]. However, at the same time scholars have stressed that an overemphasis on either board control or board collaboration may generate self-reinforcing cycles of strategic persistence, due to the creation of distrust [control-focus] or social insularity [collaboration-focus] in board-management relations [Sundaramurthy and Lewis, 2003]. Therefore, boards face the challenge to balance and integrate board control and collaboration. As pay-off, boards that succeed, will make a valuable contribute to strategic renewal processes. This results in the following hypothesis:

Proposition 2: *the interaction between the level of involvement in board control and board collaboration, is positively related to the level of strategic renewal.*

IV. MODERATORS: BOARD POWER AND ENVIRONMENTAL UNCERTAINTY

Whether the board of directors is actually able to influence the strategic renewal behavior of organizations through their control and collaboration roles is also contingent upon the two following factors: the amount of power the board has, and the level of environmental uncertainty. *Firstly*, several scholars have stressed the importance of the power base of the board of directors in their ability to contribute to strategic decision making processes [Pettigrew and McNulty, 1995; Golden and Zajac, 2001; Udueni, 1999]. Power refers to ‘the capacity of the board of directors to exert its will’ [Finkelstein, 1992: 506] upon the management board when dissonance exists between both boards. The

management board will be more receptive for the control exercised and will be more sensitive for the advice and counseling provided by the board of directors when the board is powerful. McNulty and Pettigrew [1999:60] illustrate this effect with the following quote: 'any non-exec is only as good as the executive will allow him to be. I will tell you now that any executive can kid any non-exec to do virtually nothing'. Furthermore, empirical evidence shows that the power base of the board of directors indeed moderates the relationship between the comprehensiveness of board control, the level of strategic involvement by the board, and the level of strategic change of corporations [Golden and Zajac, 2001]. These observations lead to the following research proposition:

Proposition 3: *the relationship between the interaction between board control and board collaboration, and the level of strategic renewal is stronger when the power base of the board of directors increases*

Secondly, the level of environmental uncertainty will moderate the positive relationship between the interaction of board control and board collaboration, and the level of strategic renewal. When management boards are confronted with environments that are relatively unpredictable, encompass high levels of complexity, and high levels of environmental dynamism [Volberda, 1998], they will be more receptive for the 'corrective triggers' and the 'supportive triggers' provided by the board of directors [Demb and Neubauer, 1992; Sundaramurthy and Lewis, 2003]. Because these triggers help the management board by reducing the perceived cognitive uncertainty [Rindova, 1999]. These observation leads to the following research preposition:

Proposition 4: the relationship between the interaction between board control and board collaboration, and the level of strategic renewal is stronger when the uncertainty in the corporate environment increases.

Finally, Figure 2 provides an overview of the full conceptual framework with our four research propositions.

Insert Figure 2

V. DISCUSSION AND AVENUES FUTURE RESEARCH

This paper started with the observation that boards of directors are increasingly confronted with the challenge to deal with the tensions between the conflicting requirements of their control and collaboration responsibilities, and that the influence of these roles on the strategic renewal behavior of corporations are not well understood [Goodstein et al., 1994; McDonald and Westphal, 2003; Golden and Zajac, 2001]. By presenting a conceptual framework with four testable hypothesis about the proposed relationships between both board roles and the strategic renewal of corporations, this conceptual paper attempted to contribute to the ongoing debate around the division of roles within the relationship between the management board and the board of directors. The paper especially stressed the complementarity between both board roles and the value of using a multiple lenses approach while studying the influence of board behavior. It was argued that a simultaneous implementation of both board roles may actually counter the negative effects that accrue from a overstress on one of the roles [Sundaramurthy and Lewis, 2003]. Because of the increasing convergence of the decision-control and decision-management roles in strategic decision making processes [Maassen and Van den Bosch, 1999], further investigating this issue seems important.

Four important issues pop up with respect to future research. *Firstly*, a challenge is the operationalization of the research constructs and especially the board roles. Scholars have often used the characteristics of the board of directors as proxies for the actual behavior of boards, but more direct process-oriented measures are needed. *Secondly*, the antecedents of board collaboration and board control are not well understood and need further clarification. Taking a cognitive or a social capital perspective might be helpful in this respect. *Thirdly*, the majority of studies have been carried out in corporate governance systems

characterized by a one-tier board structure. An interesting issue for future research is whether boards of directors operating in a two-tier board structure carry out their board control and board collaboration roles in a different way. The Netherlands is in this respect a very interesting country, because corporations were until 2004 forced to operate under an two-tier system. Since 2004 several organizations have adapted a one-tier board structure (Spencer Stuart, 2005). *Fourthly*, the majority of studies have been carried in corporations listed on the stock exchange. An interesting issue is in what ways the contributions of these directors vary from the contributions of boards of directors in private corporations.

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APPENDIX B: FIGURES AND TABLES

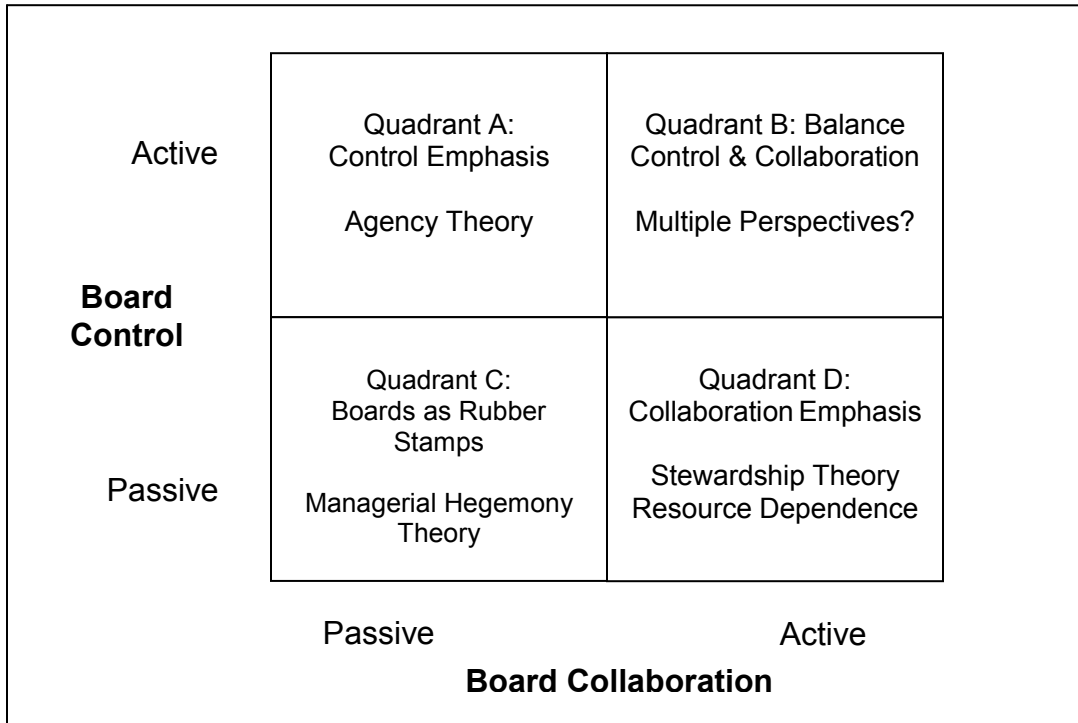


Figure 1. Board Control versus Board Collaboration

Table 1. Background Board Control and Board Collaboration

	Board Control	Board Collaboration
Activity Range:	'Board activities such as evaluating past decisions, performing reviews and monitoring executives and the corporate performance' [Fiegener, 2005:627]	'Board activities such as ratifying proposals, asking probing questions about issues, and helping to formulate and decide upon strategic alternatives' [Fiegener, 2005:627]
Key Characteristics:	Independence, distance, focus on prevention of externalities, and formal communication	Interdependence, closeness, focus on joint value creation, and informal communication
Theoretical Perspective:	Agency Theory	Stewardship Theory Resource Dependency Theory
Key Attributes:	Separation CEO and chairman position on the board, high ratio of non-executive directors to executive directors, limitations on number of board positions, and board committees composed of non-executive directors.	Joint board meetings, tenure, and educational and functional background of board of directors and management board, number of interlocking directorates, and board committees composed of executives and non-executives.

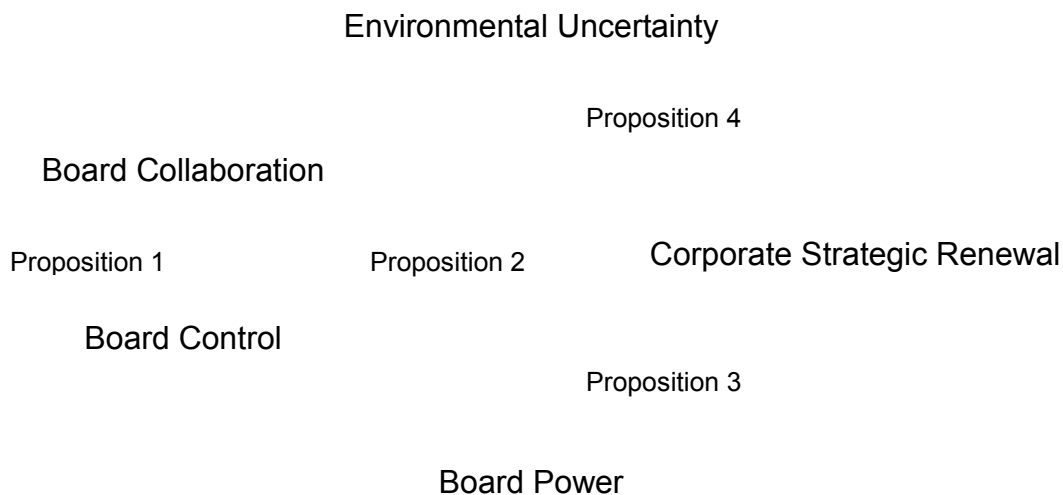


Figure 2. The Influence of Board Behavior on Corporate Strategic Renewal

Table 2. Overview Previous Studies Investigating the Board of Directors - Strategic Renewal Linkage

	Authors + Journal	Study Description	Main Findings
Board Structure and Structural Changes	Goodstein and Boeker [1991] - Academy of Management Journal	Survey data of a panel of 327 U.S. hospitals	<i>Board turnover</i> has a positive impact on strategic change.
	Goodstein, Gautum and Boeker [1994] - Strategic Management Journal	Survey data of a panel of 334 U.S. hospitals	<i>Board size and board diversity</i> have a negative impact on strategic change. <i>The percentage of outside directors</i> has no impact on strategic change.
	Zahra [1996] - Academy of Management Journal	Survey data of a panel of 138 U.S. corporations	<i>The percentage of outside directors</i> has a negative impact on strategic change.
	Zahra, Neubaum and Huse [2000] - Journal of Management	Survey data and archival data of 239 U.S. manufacturers	<i>Board size</i> has an inverted U-shaped relation with corporate entrepreneurship. <i>The percentage of outside directors</i> and CEO duality have a negative impact on corporate entrepreneurship.
	Westphal, Seidel and Stewart [2001] - Administrative Science Quarterly	Archival data of 443 U.S. corporations	<i>The percentage of outside directors</i> has no impact on strategic persistence. <i>CEO duality</i> has a negative impact on strategic persistence.
	Golden and Zajac [2001] - Strategic Management Journal	Survey data of 3198 U.S. hospitals	<i>Board size, board tenure, and board diversity</i> have an inverted U-shaped relation with strategic change. <i>Board age and business orientation</i> have a positive influence on strategic change.
	Hoskisson, Johnson and Grossman [2002] -	Survey data of a panel of 234 U.S. corporations	<i>The percentage of outsiders</i> has a positive impact on external renewal and no influence on internal renewal.
Board Processes	Beekun, Stedham and Young [1998] - Journal of Management	Survey data and archival data of 243 Forbes-100 corporations	The level of <i>board emphasis on financial controls</i> has no impact on the level of product market diversification
	Golden and Zajac [2001] - Strategic Management Journal	Survey data of 3198 U.S. hospitals	<i>Board attention to strategy and the comprehensiveness of board control</i> have a positive impact on strategic change. <i>Board power</i> moderates several relationships between board structure and strategic renewal.