

BOARD OF DIRECTORS: AN INTERNAL MECHANISM FOR THE CONTROL OF CORPORATION

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ABSTRACT

It is the responsibility of the board of directors to ensure good corporate governance. This involves a set of relationships between the management of a corporation, its board of directors, its stockholders and other relevant stakeholders. Accordingly, the board of directors must agree on the corporation's purpose (what it is for), its values (what it stands for) and the strategy to achieve its purpose. It must account to stockholders and be responsible for relations with its stakeholders. The objective of this paper is to bring into limelight the issues concerning to the board of directors as an internal mechanism for the control of corporation and its governance which are potentially of great interest, to address the progress of economy and society in general and the corporate health in particular, and have succeeded in attracting the serious academic attention. In fact the board of directors as an internal mechanism for the control of corporation and its governance is considered not just a business matter but it covers the well-being of whole economies and populations too and is a partnership question par excellence. Thus, the studies on the board of directors are significant for the benefit of the stakeholders of the corporation and the society at large. Hence, the author tries to review the recent corporate literature on the board of directors in order to increase the confidence of stakeholders in the corporate form of business organization, to justify their participation in the process of corporate governance and to overcome the negative consequences of the control of corporation on the board of directors.

INTRODUCTION

The legitimate right of the control of corporation is vested in the Board of Directors (BoD). The analysis of the composition and dynamics of the board of directors is central to the study of the control of corporation [Brown, 1976; Herman, 1981; Windsor & Greanias, 1982; and Mizruch, 1983, Wei & Zhang, 2006].

There is consensus in the corporate literature that the primary constituency, to which the BoD is accountable, is the stockholders of the corporation. The BoD as steward and legal trustee of the stockholders is responsible for the rights, interests and security of the corporation. The BoD, thus, is the permanent group responsible for the actions, activities, performance, results and future of the corporation [Loudan, 1982].

The review of the corporate literature on the BoD has indicated that today BoDs are increasingly finding their actions closely monitored by everyone, especially, institutional investors and as well as the media. Further evidence of interest can be seen in the increased level of legal scrutiny to which BoDs are subjected and in the growing competitiveness of the market for the control of corporation [Monk & Minow, 1995 and Kesner & Johnson, 1990].

However, due to the globalization, the governance role of BoD broadened than the profitability, maintenance and betterment of stockholders' wealth to financial, economic, social, ethical, environmental and legal concerns. Therefore, the BoD performs three interrelated governance functions: Legitimizing (fulfilling legal requirements); Directing (determining the mission, direction and broad strategies and policies of the corporation); and, Auditing or overseeing (ensuring the competence of management)*.

THE BOARD OF DIRECTORS AND BEHAVIOR BASED AND OUTCOME BASED CONTROL OF CORPORATION

The implementation of a control system by the BoD discussed within the existing literature on corporate control [Eissenhardt, 1988; Ouchi, 1980; Snell, 1992 and Walsh & Seward, 1990]. Several researchers have emphasized the evaluation component of control system[†]. Their research indicates that performance-based controls may focus on the behaviors of employees, the outcomes

* E.g. Bacon & Brown, 1975; Brown 1976; The Business Roundtable, 1978; Mueller, 1978; Greanias & Windsor, 1982; Loudan, 1982; Vance, 1968, 1983; and Waldo, 1985.

† E.g., Ouchi, 1977.

of employee behaviors, or some combination of behaviors or outcomes. Under a system of behavior-based controls employees are evaluated and rewarded based on how well they perform the tasks or actions comprising their jobs.

By contrast, outcome-based controls are concerned only with results. Employees are evaluated and rewarded based on how well those results meet the expectations of a corporation. In applying these concepts to the relationship between the BoD and top management, Bysinger & Hokisson, [1990] indicated that behavior-based controls typically include an assessment of the strategic "Desirability" of top management's decisions. Conversely, outcome-based controls focused primarily on the degree to which top management is able to meet performance criteria, e.g., return on assets.

The literature on the control of corporation suggests that the BoD's performance for behavior or outcome-based controls may depend in part on the cost and difficulty of obtaining information on the performance-related behavior of top management [Pastor & Veronesi 2003]. Thus, while behavior-based controls are more accurate from a measurement standpoint, they are also more costly to implement [Scott, 1987]. The higher cost derives from the need to acquire detailed information on performance-related behaviors. Such information can be obtained through direct observation of employee behavior or indirectly through information system [Eissenhardt, 1988].

A number of empirical studies indicate that as the difficulty of obtaining information on employee behavior increases, employers are more likely to use outcome-based controls. For example, outcome-based controls appear to be more common in settings where direct observation of employee behavior is limited by the wide span of control of supervisors and where employee deviations from job requirements are difficult to detect through standard oversight mechanisms [Eissenhardt, 1988 and Lorsch & Elaine 1989].

Baysinger & Hoskisson, noted that "The emphasis given to control system measures and rewards not only motivates and reinforces behaviors but where the employee who is evaluated has decision making responsibility, also influences the nature (e.g., risky-ness) of his/her decisions" [1990:73].

Eisenhardt, [1988] has focused on the impact of outcome-based control of management behavior. He implied that using outcome-based controls transfers risk to the Chief Executive Officer (CEO) because outcomes are based partly on CEO's decisions and behaviors and partly on a number of factors, which are outside the control of CEO. As a result, outcome-based controls may encourage CEO to pursue low-risk activities that promise short-term gains. Simultaneously, CEO is likely to avoid business activities that are potentially profitable but are also risky with long-term horizons [Baysinger & Hoskisson, 1990; Baysinger, Kosnik, & Turk, 1991; and Gomez-Mejia & Balkin, 1992].

SIZE OF THE BOARD OF DIRECTORS

It has been observed by the researchers that the responsibilities and functional role of BoD relate to its diversity and size [Judge & Zeithaml, 1993 and Alexander, Femel & Halpern, 1993]. BoDs, larger in size, which tend to be more diverse in terms of the experience and background of their members, typically have an external focus. Contrary to this, those BoDs, which are smaller in size, tend to be less diverse and have an internal focus.

EXECUTIVE AND NON-EXECUTIVE DIRECTORS ON THE BOARD OF DIRECTORS

In the corporate literature, a considerable debate addressed the ratio of executive (inside) directors to non-executive (outside) directors sitting on the BoDs [Francis, Olsson & Schipper 2004 and 2005]. The portion of BoDs composed of non-executive directors (sometime called part-time directors) represents one dimension of formal structure independence from the management of a corporation. It is the responsibility of both, inside as well as outside directors, to monitor and oversee the corporate strategy.

Agency theory and legal perspectives on BoD emphasize that outsiders have the potential to evaluate strategic decision making more objectively [Zahra & Pearce, 1989; Fama & Jensen, 1983 and Brudney, 1982], as outsiders are not bound or, "beholden to Chief Executive Officers for their jobs" [Fredricken, Hambrick & Baumrin, 1988: 262]. They are seriously asked questions or potentially more willing to challenge the CEOs position on strategic issues [Boeker, 1992]. Increases in the proportion of outsiders on the BoD, therefore, may prompt CEOs to seek greater interpersonal, informed influence as a substitute for the structural source of power linked with having more subordinate managers (insiders) as directors on the BoD.

Baysinger & Hoskisson, [1990] argue that the mix of outsiders and insiders on the BoD is likely determinant of the BoD's choice of managerial control. They note that outsider, by definition, are BoD members who are not involved in the day-to-day operations of the corporation. Since outsiders lack the opportunity to observe CEO performance-related behavior directly, they are likely to prefer outcome-based controls. However, this inclination of outsiders towards outcome-based controls may be tempered by the presence of insiders on the BoD. Insiders are often in a position to gauge directly the quality of the CEO's leadership and decision making and can convey their observations to the outsider members of the BoD.

A key question in this context relates to the number or percentage of insiders needed to counter balance the outsiders' inability to observe directly the performance-related behavior of CEO. Indeed, the critical mass of insider representation is not known and may be contingent on a number of organizational factors. However, as the proportion of outsiders on the BoD increases, there is likely to be a decline in the amount and breadth of information available to the members of BoD about the CEO's performance-related behavior [Hokisson, Johnson, & Moesel, 1994].

Even if the BoD dominated by non-executive directors and has an external orientation, certain mechanisms exist that increase the BoD's access to information about the CEO's performance-related behavior. One such mechanism is the meeting of BoD. If the CEO attends the meeting of BoD and if such meetings are held often, this will enhance the opportunity for members of BoD and the CEO to interact. Lorsch & Elaine describe meetings of BoD as one of the few times members of BoD have an opportunity to observe "...how top managers perform on their feet, how they react to questions and how they think" [1989:65]. Thus, information gathered through the meetings of BoD will provide directors with a basis for evaluating the CEO on criteria other than performance outcomes.

Besides being able to observe the CEO's behavior at such meetings, BoD members may also become more familiar with his/her habits and values. Accordingly, BoD's members may develop affect toward the CEO. Specifically positive affects may encourage the CEO to be more open with the BoD's members and to provide them with information on which to base their evaluation. Because of this increased flow of information a BoD that meets frequently and interacts with the CEO will be less likely to emphasize outcome-based controls.

CORPORATE DIVERSIFICATION AND THE BOARD OF DIRECTORS

According to several theoretical perspectives, including managerialist and agency theory, top managers have personal incentives to pursue corporate diversification beyond the level at which stockholders wealth is maximized [Amihud & Lev, 1981; Hill & Snell, 1988 and Hokisson, Johnson & Moesel, 1994]. From these perspectives, top managers are over invested in the firm relative to diversified stockholders and their jobs, reputation and career prospects are highly dependent on the firm's performance. Given that a major objective of unrelated diversification reduces these career risks while also stabilizing the CEO's personal income. Stockholders obviously avoid the career risks faced by the CEO, and they avoid firm-specific investment risk through

portfolio diversification. Thus, stockholders should favor lower levels of diversification than managers should.

Organizational theorists have long argued that a variety of other behavioral factors lead managers to prefer diversification levels that are excessive, from the perspective of stockholders. Managers may pursue diversification simply to enhance their personal status and visibility. Evidence suggests that managers become overly attached to the acquisitions they make and overly committed to their prior decisions to expand into new businesses; moreover this commitment is thought to extend to other insiders on the management team.

Several researchers have suggested that independent directors may help counteract management's commitment to maintain diversification [Bebchuk & Fried 2004]. In the absence of alternative sources of CEO influence, therefore, more structurally independence BoD, as relatively objective representatives of stockholders' interests, should prompt lower levels of corporate diversification (e.g., by forcing management to shed unrelated businesses). Conversely, the use of ingratiating and persuasion tactics should help CEOs build directors' support for their strategic preferences by securing social obligations, biasing evaluations of the CEO's decision making capabilities and raising directors' confidence in the diversification strategy itself.

STRATEGY AND THE BOARD OF DIRECTORS

It is widely argued in some scholarly oriented writings that BoD should be active in policy making and strategy [Demb & Neubauer, 1992]. However, theoretical and empirical writing about BoDs and directors is inadequate in its treatment of strategy. For instance, control is a major theme in writing about BoDs. Agency theorists [Jensen & Meckling, 1976 and Kosnik, 1987], view a BoD as a mechanism to ensure that top management actions are in accord with stockholders interests. The purpose of a BoD is to monitor top management and resist the opportunities and self-interested behavior of managers. Performance incentives in the form of compensation and the ability to hire and fire managers are

seen as means to ensure that incentive structures for managers accord with stockholders interests [Fama & Jensen, 1983]. However little has been said by agency theorists about strategy as a means of control over managers.

Unlike agency theorists, resource dependency theorists do not assume that managers and owners have different interests. They emphasize the institutional role of BoD in helping to link the corporation to its environment and to secure critical resources. BoDs are viewed as mechanisms for reducing environmental uncertainty [Pfeifer, 1972 and Pearce & Zahra, 1991]. However, whilst resource dependency theorists direct attention to the role of BoDs in attaining resources, they do not consider the use of such resources [Finkelstein & Hambrick, 1988 and Stiles & Taylor, 1996].

The strategic management literature is also largely silent on BoDs' involvement in the strategy. Finkelstein & Hambrick [1988] criticized the strategy field for being populated by descriptive and prescriptive strategy framework, which omits attention to senior executives and BoDs.

There is a significant gap between prescription that BoDs should be active in strategy and empirical evidence that BoDs are indeed active in strategy. A review of literature about BoDs concluded that there is a dearth of work on BoD involvement in strategic decision-making [Finkelstein & Hambrick, 1988]. Those studies identified by Finkelstein & Hambrick, [1988] about the effects of BoDs on strategy do not provide a conclusive set of findings about the impact of BoDs on the strategic behavior of firms [Hill & Snell 1988; Pearce & Zehra, 1991; and Judge & Zeithaml 1992]. Empirical studies close to boardroom behavior also provide a mixed set of findings about the involvement of BoD and non-executive members of BoD in strategy.

Early work is skeptical about the involvement of BoD in strategy and concluded that BoDs have not involved in strategy formation [Mace, 1971; Herman, 1981 and Lorsch, & MacIver,

1989]. Lorsch & Maciver [1989] found that the primary role of BoDs in the strategy formation process was, in advising and evaluating, rather than in initiating strategy.

DEMOGRAPHIC CHARACTERISTICS AND THE BOARD OF DIRECTORS

Most scholars agree that predictions about the performance implications of demographic variables are presumed to operate through some set of intervening processes [Arlen & Talley 2003; Cremers, Nair & Wei 2004]. However, there has been debate over whether the direct study of those intervening processes is necessary. Pfeffer, [1983], for example argue that the study of such processes is not necessary, because executives' beliefs and behaviors can be inferred successfully from demographic characteristics.

The corporate literature reviews have concluded that the research on BoDs has failed to establish any clear consensus as to which demographic characteristics lead to which outcomes even in the most well researched areas [Daily & Schwenk, 1996; Johnson et al., 1996 and Zahra & Pearce 1989]. This conclusion suggests that the influence of the demography of BoDs on the performance of firm may not be simple and direct as many past studies presume, but, rather, complex and indirect. To account for this possibility, researchers must begin to explore more precise ways of studying the BoDs demography that account for the role of intervening processes.

The assumptions that underlie the search for direct demography-performance links have been shown to be unreliable. In an intensive review of past demographic research, precisely for the purpose of evaluating the assumption that it is unnecessary to test the inferences involved in demography-outcome relationships. It is found that, in a majority of cases, the explanations offered for demography-outcome relationship studies are not supported by the studies in which researchers have actually examined the intermediary process phenomena. Findings also dispute the notion

that executive beliefs and behaviors can be inferred reliably from demographic variables alone.

OWNERSHIP, PERFORMANCE AND THE BOARD OF DIRECTORS

Stock ownership by the board of directors and management varies substantially across firms. This cross-sectional variation provides the basis for relation between the ownership and firm behavior. Mock, Shleifer & Vishny [1988] examine the cross-sectional relation between measures of firm performance and the ownership stake of the BoD. They report a strong relation between performance measure and ownership stake, but the relation is not monotonic. The relation between performance and ownership applies both for ownership by non-executive member of BoD and managers.

The tradeoffs between the alignment of stockholder / manager interests and managerial entrenchment imply a non-monotonic relation between insiders' holdings and the value of a given firm. Managerial interests become more closely allied with stockholders' as inside stock ownership rises. An increase with ownership until inside stock ownership is large enough to begin to give managers control, at which point entrenchment begins to occur, and as this happens value declines with ownership. From this point increases in managerial holdings causes firm value to rise because such increase cause managers' interests to be more closely aligned with stockholders.

A caveat to the entrenchment / alignment interpretation of the cross-sectional evidence, however, is that it treats ownership as exogenous and does not address the issue of what determines ownership concentration for a given firm or why concentration would not be chosen to maximize firm value [Ashbaugh, Lafond & Mayhew 2003]. Managers and stockholders have incentives to avoid inside ownership stakes in the range where their interests are not aligned, although managerial wealth constraints and benefits from entrenchment could make such holdings efficient for managers.

Nonetheless, the notion that firm characteristics can affect ownership is useful and is also suggested. Demsetz, & Lehn, [1985] and Brickley & Dark, [1987] present evidence that variation in ownership structure is partly explained by variation in firm characteristics, such as size and location. In addition, Holderness & Sheehan, [1988] found no evidence that majority ownership managers can be explained as an attempt to expropriate resources from stockholders. They document that majority-stockholders firms survive over time but the authors do not fully investigate the characteristics that would make it optimal for a firm to be majority controlled. In sum, the direction of causality between ownership concentration and firm characteristics is an important question raised, but not entirely resolved, by the work exploiting cross-sectional variation in the ownership. Although the evidence indicates that firm characteristics and inside stock ownership are related, disentangling the causal relation between inside stock ownership and firm value require additional investigation.

CONCLUSIONS

Board of Directors is the central construct in the control of corporation and its governance. It is one of the internal control mechanisms which monitors not only the efficiency of top management but also keeps its eye on the overall performance of corporation. BoD can assist stockholders in evaluating the performance of its management and can control management perquisites, consumptions and entrenchment by adopting a range of short-term (e.g., by using reward system) and long-term (e.g., by changing corporate structures) solutions. Hence when effective, the BoD as an internal control mechanism can resolve traditional agency problems. Typically, effective internal control mechanisms are associated with the model of corporate governance, where stockholders can actively use BoD to control the management of corporation.

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