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Board leadership structure and diversity over CEO time in office: A test of the evolutionary perspective on Italian firms

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ABSTRACT

An evolutionary perspective on CEO-board relations suggests that CEO objectives and interests change over time, and that board roles should shift accordingly, from CEO leadership development during the early stages of CEO time in office toward monitoring during the latest stages. This study examines how two board characteristics, board leadership structure and board diversity, shape innovation investment among Italian firms. Empirical results support the hypothesized effects, suggesting that the board's effects are contingent upon CEO time in office.

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Introduction

Agency theory – by far the dominant paradigm in the field of corporate governance (Daily, Dalton, & Cannella, 2003) – maintains that, given the opportunity, self-serving executives maximize their utility at the expense of shareholders; boards of directors monitor executives' behaviors, protect shareholders' wealth, and enhance firm outcomes (Jensen & Meckling, 1976). Stewardship theory provides an alternative view of managerial behaviors: it conceives executives as stewards of the organization, who act in the best interests of their principals (Davis, Schoorman, & Donaldson, 1997; Donaldson & Davis, 1991): if the firm's primary goal is to maximize returns to shareholders, CEOs will work toward this goal; governance structures, such as boards of directors, should empower CEOs rather than control them, avoiding constraints that reduce their impetus to pursue long-term, pro-organizational goals.

Given these opposite predictions, scholars have long contraposed agency and stewardship theories (Davis et al., 1997), but there is a growing recognition that both theories may give insight into managerial behaviors and motives (Hernandez, 2012). This study inquires into how superior explanations of board effectiveness can be developed by combining the agency and stewardship perspectives; it does so by examining innovation investment over the CEO tenure cycle in one specific governance context, Italian firms. Such an inquiry is important for several reasons.

First, drawing from agency theory, governance scholars have long examined whether board independence is beneficial, but results have been equivocal, suggesting that independence both increases and decreases innovation investment (Baysinger, Kosnik, & Turk, 1991; Hill & Snell, 1988; Hoskisson & Hitt, 1988; Kor, 2006; Lippman & Rumelt, 1982) and firm performance (e.g., Baysinger et al., 1991; Berg & Smith, 1978; Coles, McWilliams, & Sen, 2001; Daily & Dalton, 1994; Deutsch, 2005; Hill & Snell, 1988; Johnson, Daily, & Ellstrand, 1996; Rechner & Dalton, 1991; Zahra, 1996). The conflicting findings call for reconsidering agency arguments and expanding research to other theoretical perspectives: Daily et al. (2003) assert that "researchers and practitioners *must reconsider* the relative weight placed on directors' oversight function" (2003, p. 375) and bring to bear other theoretical perspectives, such as stewardship theory (2003, pp. 375–376). To date, it is still unclear whether conventional models of boards correctly capture actual effects of board structures: since agency and stewardship theories offer opposite predictions on independence, identifying contextual factors in which each theory prevails may help reconcile conflicting empirical findings.

Second, while there is a growing consensus that agency and stewardship theories may be used as complementary perspectives to examine managerial behaviors, and that each theory best applies under specific management situations (Fehr & Fischbacher, 2002, 2003; Fehr & Schmidt, 1999; Fong & Tosi, 1992; Hernandez, 2012; Shen 2003), this work has been mostly theoretical, and there has been little research seeking to develop new predictions on board effectiveness from a combined view (Boyd, 1995; Hernandez, 2012; Krause & Semadeni, 2013; Shen, 2003). Specifically, Shen (2003) posits that CEOs' interests and goals evolve from stewardship tendencies early in CEO tenure towards agency concerns in later stages; but he does not develop predictions about how varied board configurations (e.g., leadership

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structure, diversity) affect CEO behaviors and firm outcomes over the CEO tenure cycle. In sum, research seeking to combine agency and stewardship perspectives is growing, calling for an depth examination of contextual factors that disentangle effective applicability of the two theories.

Third, because most research on boards has examined public companies in the United States (Boyd, Haynes, & Zona, 2011; Johnson, Schnatterly, & Hill, 2013), there is scant evidence that established theories extend globally to different governance contexts. In particular, research has shown that in highly transparent environments and efficient capital markets, both good corporate governance and greater R&D spending are associated with positive market reactions (Chauvin & Hirschev, 1993; Griliches, 1981), which immediately translate into greater stock appreciation; thus CEOs with stock options have an interest in creating the appearance of good governance, to capitalize on positive market valuations: indeed, some have charged that what is done in the name of good governance is just an attempt by executives to positively impress capital markets (Westphal & Zajac, 2013) while undermining the actual effectiveness of corporate governance (Bebchuk & Fried, 2004; Westphal, 1998). Examining governance theories in contexts other than US constitutes a further test of validity for governance theories: does good governance improve outcomes in contexts such as Italy, where the economy is not so transparent, capital markets are less efficient (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000; Sapienza, 1999), compensation package rarely include stock options (Melis, Carta, & Gaia, 2012), and, hence, where CEOs have less incentives to solicit market appreciation via formal governance structures? Examining agency and stewardship theories among Italian firms may respond to recent call to extend research globally, in contexts other than United States (Boyd et al., 2011; Johnson et al., 2013).

Fourth, in terms of practical implications, standards of good governance worldwide mostly reflect agency theory's concerns, and generally recommend or impose strong controls on executives' behaviors: in spite of the absence of any substantive, systematic relationship between board independence and firm performance, governance experts, policy makers, and practitioners consistently advocate greater independence as a best practice (MacAvoy & Millstein, 2004; Monks & Minow, 2008). Clarifying the conditions in which each theory best applies may nurture a new debate about what is actually meant by "good governance" and under which specific conditions control or empowering favor shareholders' interests in particular contexts, such as the Italy's economy.

The present study aims to address these challenges: it examines how a combined agency-stewardship view helps develop valuable predictions on board effectiveness. It builds on the evolutionary model by Shen (2003) to suggest that two specific aspects of boards, i.e., leadership structure and diversity, exert varied effects over the CEO tenure cycle. It tests hypotheses on a sample of Italian firms and adopts innovation investment as a dependent variable.

Firm innovation refers to a company's commitment to creating and introducing products, processes, and organizational systems (Covin & Slevin, 1991); it constitutes a key antecedent of firm success in current modern economies (Kor, 2006; Lumpkin & Dess, 1996; Stopford & Baden-Fuller, 1994). Innovation investment encompasses multiple domains, including product and process development, R&D expenses, and patenting (Zahra, 1996; Zahra, Neubaum, & Huse, 2000), and is appropriate to test the evolutionary perspective on CEO-board relations, which combines agency and stewardship theory over time. First, innovation initiatives are vulnerable to managerial opportunism (Block & MacMillan, 1993; Crawford, 1987; Lee & O'Neill, 2003), and agency scholars predict that board independence reduces the risk of underinvestment (Baysinger et al., 1991; Hill & Snell, 1988; Hoskisson & Hitt, 1988; Lippman & Rumelt, 1982; Zona, 2012); in addition, innovation investment also engenders uncertain benefits in the long run, while anticipating costs in the near term, in accord with stewardship theory's contention that CEOs tend to act in the long-term best interest of the firm, even at the cost of sacrificing short-term performance (Hernandez, 2012; Shen, 2003). Second, because innovation initiatives involve complex decision making, multiple intricacies (McKenna, 1995), and collective knowledge sharing (Gibbons, Nowotny, & Schwartzmann, 1994; Howells, 1996), they entail firm-specific learning processes that unfold over the CEO tenure cycle; on the other hand, executives tend to become committed to their past actions as time progresses (Salancik, 1977; Staw, 1976), so that innovation investment is sensitive to where a CEO is in his/her tenure cycle. Empirical studies have examined the relationship between tenure and innovation (Musteen, Barker, & Baeten, 2006): Wu, Levitas, and Priem (2005) show that an inverted U-shaped relationship exists between CEO tenure and invention. We predict that board leadership structure and diversity moderate this inverted U-shaped relation in such a way, that the magnitude of effects differ over CEO tenure cycle.

This article unfolds as follows. The next section briefly summarizes current and previous research on boards of directors; it then describes the evolutionary model of CEO-board relations. A subsequent section develops the hypotheses on board leadership structure and diversity. A methods section and a results section follow. The last section discusses the empirical findings and concludes.

Theory background

In past decades much research on boards relied on agency theory, presuming that independent boards—by curbing executives' tendencies to expropriate wealth from shareholders—improve firm performance (Jensen & Meckling, 1976). A recent literature review (Boyd et al., 2011) examines empirical research on CEO-board relations over 25 years: central perspectives in this research include agency, resource dependence, upper echelons, stewardship, social network, and institutional, but agency theory is by far the dominant perspective, "utilized in well over half of the published papers" (2011, p. 1902). In addition, "roughly 96% of the papers reviewed were based on samples of US firms" (2011, p. 1911). Boyd and colleagues call for more investigation of whether "theories largely developed in the Anglo-American context" apply in other contexts (2011, p. 1914) and also call for more "studies based on multiple theories" to "explore the strengths and weaknesses of different theories in particular settings" (2011, p. 1902).

Combining agency and stewardship theories may be particularly suited for a multi-theory study on CEO-board relations: there is a growing recognition among governance scholars that, in practice, executives' behaviors may be shaped by multiple motives, including both self-regarding agency and other-regarding stewardship, such that integration of the agency and stewardship perspectives may offer a richer explanation of board functioning and performance. For example, economists Fehr and colleagues (Fehr & Fischbacher, 2002, 2003; Fehr & Schmidt, 1999; Fong & Tosi, 1992) theorize that agents may develop "social preferences" based on fairness concerns, reciprocity, or altruism, which induce behaviors that benefit other agents; Hernandez (2012, p. 185) posits that "organizations occupy a place along a continuum anchored by stewardship and agency" and concludes that "the structural factors within organizations represent a pendulum anchored by stewardship and agency governance approaches, which can swing from one end to the other"; and Shen (2003) suggests that CEO goals and motives may evolve from stewardship concerns to agency concerns as CEO tenure lengthens: building on this model, we posit that because the board and the CEO make decisions jointly (Forbes & Milliken, 1999), and CEO goals evolve over time in office, board

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