



Integrating agency and resource dependence theory: Firm profitability, industry regulation, and board task performance



Amedeo Pugliese ^{a,*}, Alessandro Minichilli ^b, Alessandro Zattoni ^{c,d}

^a Queensland University of Technology School of Accountancy, 2 George St, 4001 Brisbane, Australia

^b Bocconi University, Department of Management and Technology, Milan, Italy

^c Parthenope University, Department of Business Economics, Naples, Italy

^d SDA Bocconi School of Management, Strategic and Entrepreneurial Management Department, Milan, Italy

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ABSTRACT

Boards of directors are key governance mechanisms in organizations and fulfill two main tasks: monitoring managers and firm performance, and providing advice and access to resources. In spite of a wealth of research much remains unknown about how boards attend to the two tasks. This study investigates whether organizational (firm profitability) and environmental factors (industry regulation) affect board task performance. The data combine CEOs' responses to a questionnaire, and archival data from a sample of large Italian firms. Findings show that past firm performance is negatively associated with board monitoring and advice tasks; greater industry regulation enhances perceived board task performance; board monitoring and advice tasks tend to reinforce each other, despite their theoretical and practical distinction.

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1. Introduction

The roaring collapses of highly profitable firms like Enron and Parmalat in the early 2000s sounded as corporate governance paradoxes: their boards were composed of prominent and knowledgeable managers, academics and professionals, and ticked all the boxes of the best governance practices. Nonetheless, they filed for bankruptcy with multi-billionaire losses for their shareholders, bondholders, workers and the society at large (Coffee, 2005). These cases cast doubts on the collective understanding of what boards do, prompting numerous calls to move beyond the demographics and provide a systematic analysis of board behavior (Dalton, Hitt, Certo, & Dalton, 2007).

Despite the wealth of research on boards of directors, there is still a quest for a deeper understanding of what drives board task performance (Huse, 2007). Boards are expected to perform two tasks: monitoring managers and firm performance, and providing advice and access to resources (Hillman & Dalziel, 2003). Prior studies explaining board monitoring or advice tasks rely upon board composition (Le, Walters, & Kroll, 2006), or micro-level determinants – as board processes and cognitive conflicts – (Forbes & Milliken, 1999), and macro-level factors (Minichilli, Zattoni, Nielsen, & Huse, 2012).

In almost all instances, researchers analyze monitoring and advice tasks separately. More recently the literature highlights the need to

move beyond this “static view”, integrating the two perspectives underlying board monitoring (agency theory) and advice (resource dependence theory) tasks (Hillman & Dalziel, 2003). This is further reinforced by Ocasio's attention-based view (ABV), suggesting that decision-making bodies as the board of directors do not constantly engage in all activities, “but place different emphasis on their tasks according to the various issues and answers they focus on” (1997: 188). Ocasio indicates that boards' engagement into the different tasks depends on the contextual conditions boards and organizations are embedded into (Ocasio & Joseph, 2005), thus sparking a number of studies using a contingency approach to boards (Filatotchev & Nakajima, 2010).

Building on these perspectives, this study seeks to empirically assess whether past firm performance and industry regulation affect board monitoring and advice tasks. The data are drawn from a sample of Italian largest companies, whose CEOs responded to a detailed questionnaire. Findings are in line with prior works indicating that board demography does not affect board monitoring and advice tasks (Finkelstein & Mooney, 2003), and in addition show that past performance is negatively associated with board monitoring and advice, whereas greater industry regulation enhances both tasks.

This study enhances understanding of how boards operate: first, by providing evidence of the effects of past firm performance on board monitoring and advice tasks, whereas most of the existing literature is concerned with the effects of board behavior on the subsequent performance. Second, by showing that greater industry regulation increases a board's attention towards monitoring and advice tasks. Third, by

* Corresponding author. Tel.: +61 7 3138 1022.

E-mail address: amedeo.pugliese@qut.edu.au (A. Pugliese).

suggesting that despite the different theoretical underpinnings, and distinct measurement construct, board monitoring and advice tasks are strongly correlated (boards that are perceived to monitor tend to be considered active in their advice task as well).

These findings have implications for practice: the literature does not posit the dichotomous view of the board as monitor versus advisor; rather, researchers posit boards to be either active in the two tasks or less engaged overall. A more general concern arises with boards in high performing firms: according to the findings these are reluctant to perform the expected tasks; ultimately, there is a potential threat for high performing firms that board hold back, thus imposing higher vigilance on boards' engagement.

The remainder of the paper is structured as follows. Section 2 illustrates the theoretical background and derives hypotheses. Section 3 follows a description of the sampling procedure and the method. Section 4 reports the findings before discussing implications for theory and practice. Section 5 concludes with the limitations and possible avenues for future research.

2. Board task performance

Board task performance is defined as the “board's ability to perform its control and service tasks effectively” (Forbes & Milliken, 1999: 493). These tasks refer to the activities a board performs to comply with regulation and shareholders' expectations. The two tasks are theoretically distinct and are made up of different activities. Board monitoring is rooted into agency theory (AT) (Fama & Jensen, 1983): boards are expected to monitor activities and decisions in order to ensure that shareholders' interests are met. The watchdog function is amplified in the case of separation between ownership and control, that is, when managers do not bear a major stake of wealth effects of their decisions (Coffee, 2005). However, the legal nature of the board imposes monitoring as a primary task for the board regardless of the organizational forms (Bainbridge, 2002): directors are required to oversee a firm's activities as a part of their “duty of care” towards the company and all key stakeholders (Blair, 2012).

Beside the monitoring task, resource dependence theory (RDT) proposes that boards provide access to resources that are not otherwise available (Pfeffer & Salancik, 1978); RDT sees boards as asset of the firm contributing to sustained value creation (Hillman, Withers, & Collins, 2009). The advice or resource provision task includes advice on strategic initiatives, an active involvement in decision-making, and follow-up on strategic choices.

The two tasks stem from different theoretical traditions, suggesting a stylized model of what boards (should) do, and how to enhance monitoring and advice respectively. The distinction affects both researchers' understanding of boards, and a firm' search for good directors: board monitoring emphasizes directors' independence and ability to challenge managers who are not acting in the best interests of stakeholders; board advice envisions that board capital is a key factor in enhancing advice and resource provision (Sundaramurthy & Lewis, 2003).

The theoretical distinction underlying the two tasks and its implications in terms of regulatory provisions and expected board behavior shapes the development of research. Traditionally governance scholars explored how board composition impacts on firm or board task performance (Daily, Dalton, & Cannella, 2003). The so-called “usual suspects” (board independence and size, CEO duality, board ownership) account for a limited part in explaining board task performance (Forbes & Milliken, 1999), while board processes, cognitive conflicts and effort norms are better predictors of engagement (Hendry, Kiel & Nicholson, 2010; Minichilli et al., 2012). Studies on boards of directors downplay the role of firm or context specific conditions on board behavior (Bamberger, 2008), and the numerous calls for additional research overcoming these limitations have only received partial fulfillment (Dalton & Dalton, 2011).

Ocasio (1997) offers an alternative view and challenges the idea of boards being constantly involved into their tasks: the ABV proposes

that boards, as all decision making bodies, selectively choose where to address their efforts. Such selectivity is due to time constraint and prioritization, board members' bounded rationality and limitation in information gathering, thus impairing boards' ability to perform their tasks. The work of Hillman and Dalziel (2003) and Sundaramurthy and Lewis (2003) further develops this view, highlighting the paradox of control and collaboration within board of directors, and proposes an integration of the two views. The application of ABV to the understanding of decision-making bodies is yet more profound: Ocasio identifies patterns to ascertain how boards distribute and regulate their attention to their tasks (focus of attention) through the development of the concept of situated attention. What tasks boards focus on, and what they do, depend on the specific context or situation they find themselves in (1997:188). Barnett (2008) provides additional theoretical backing to this stream of research, indicating that board configurations and actions are highly dependent on the set of internal and external conditions that firms face.

Recent empirical works support these intuitions: Tuggle and colleagues (2010) find significant variation in how boards prioritize board monitoring according to changing profitability. Zhang (2010) explores the board transitioning between information seeking and strategic actions, when process-based conditions vary. Yu, Engelman, and Van de Ven (2005) build on ABV and observe how organizational structure influences aspects of the merger integration process managers attended to over time.

2.1. Firm profitability and board task performance

This study investigates the effects of firm and industry characteristics on board monitoring and advice tasks. With respect to boards' allocation of attention to monitoring and advice tasks, firm performance and industry regulation are considered as relevant factors (Boyd, Haynes, Hitt, Bergh, & Ketchen, 2012): first, past and current firm performances matter because of the use of directors as a means to assess managerial effectiveness (Walsh & Seward, 1990). Second, industry regulation matters to boards because of the emphasis on interactions, compliance to norms and resource provisions required, conditional on the different levels of regulation (Cho & Hambrick, 2006).

Past firm performance influences boards' engagement into monitoring and advice tasks. This is consistent with evidence of a bi-directional relationship of firm performance and governance structures (Platt & Platt, 2012): the board and CEO affect firm performance, but profitability it also affects them. However, while boards' effects on subsequent firm performance have received wide attention (Pugliese et al., 2009), the impact of past and current performances on board tasks is not fully exploited.

Firm profitability is generally employed to assess how well (or poorly) executives operate. A few studies subvert this logic by exploring how firm profitability affects board composition and structure (Gales & Kesner, 1994; Mueller & Barker, 1997). These examine extreme cases of bankruptcy, showing that negative returns often lead to changes in board and leadership structures (Daily, 1995). This study takes a different stand and posits that boards in high (low) performing firms behave differently in relation to their focus on monitoring and advice tasks. To our knowledge, no study has investigated whether past and current profitability affects boards' monitoring or advice tasks.

In poorly performing firms, boards are supposed to be active monitors. This role is fully consistent with predictions of AT indicating that the substitution of poorly performing managers is one of the mechanisms in place to ensure shareholders' interests are met (Walsh & Seward, 1990). Poor performing firms require a more vigilant approach from their boards: managers who caused the poor performance should be evaluated, and fired, if necessary. This is also backed by a legal perspective: directors of distressed firms are more likely to engage in monitoring activities, reducing the threat of litigation due to a breach in their duty of care towards shareholders (Bainbridge, 2002).

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