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The Effects of Top Management Team External Ties and Board Composition on the Strategic Choice of Late Movers

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Within the context of the monitoring and control function of the board, we extend previous work on the agency view of governance. We examine how the top managers' external ties and board composition directly and interactively influence the strategic choices of firms. Our results indicate that top managers with intra-industry knowledge and experience tend to adopt a resource-imitation strategy whereas those with knowledge and experience from other industries tend to adopt a resource-substitution strategy. The separation of CEO and board chairperson duties also affects strategy selection. In terms of interaction effects, we find that boards with a high ratio of outsiders reduce the tendencies of managers to opt for the safe strategy solutions with which they are familiar.

Introduction

Ever since Berle and Means (1932) discussed the separation of ownership and management in the "modern corporation," it has been accepted that the role of the board of directors is to act as fiduciaries for the owners. As such, shareholders have entrusted the board to monitor and control managers to minimize agency problems. Arguably, that trust was misplaced. After the problems of misleading financial disclosures which erupted in the late 1990s and early 2000s (Wintoki, 2007), and following arguments that have long been made in the governance literature (Fama, 1980; Fama and Jensen, 1983; Jensen and Meckling, 1976), there were calls by stock-exchange officials to increase the number of outsiders on boards and to separate the roles of CEO and chairman. Despite the soundness of the theoretical arguments which link both of those actions with improved decision-making and consequent firm performance, empirical research has not produced clear support for either (Dalton et al., 1998; Golden and Zajac, 2001; Langevoort, 2001). Methodological issues aside, that outcome likely reflects the fact that the research has focused on main effects, rather than digging more deeply into behavioral and interactive effects between the board and top managers (Daily et al., 2003).

Judge and Zeithaml (1992) found that boards could be involved in the process of formulating strategic decisions, and Westphal (1999) showed how boards could influence strategic decision-making through advice-giving interactions with CEOs (please also see O'Neal and Thomas, 1999; Westphal and Fredrickson, 2001; Wu, 2008). More recent research has focused on the idea of collaboration between the board and management in deciding strategy (e.g., Hendry et al., 2010; Zhang et al., 2011). In many respects, that thinking blurs the line between agent and fiduciary. In other research on governance, it has been assumed — either implicitly or explicitly — that boards exercise relatively little independent influence over the firm's strategic direction (Baysinger and Hoskisson, 1990; Johnson et al., 1996; Zahra and Pearce, 1989). Rather than directing strategic decisions, outside directors are thought to support managers by co-opting financial institutions, helping to avoid hostile takeovers, and perhaps providing information and expertise which aids in the implementation of management's strategy, without determining the strategy itself (e.g., Davis et al., 1994; Mizruchi, 1996). In reviewing this literature, Finkelstein and Hambrick (1996) noted that behavioral perspectives on boards have been "virtually uniform" in their assumption that "boards of directors are not involved in strategy formulation."

Clearly, some boards get involved in strategy making, but the preponderance of evidence supports the position of Finkelstein and Hambrick. Thus, if the board's role is primarily one of monitoring and control, and direct beneficial effects on strategy are unconfirmed, then the question remains: do interaction effects between the board and top management team (TMT) have an effect on strategy selection within the context of monitoring and control? In this work, we theorize about and test interactions between top managers and the board, but retain the agency perspective that a key function of the board is monitoring and control. Our work is thus based on the premise that managers will seek to benefit themselves at the expense

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of possible returns to owners. Therefore, the job of the board is to prevent that from happening by making sure the best strategy for shareholders is selected, which may not be the one managers prefer.

As a baseline, we start by establishing how TMT experience affects strategy selection. We then go on to address the issue of interaction by asking whether or not board composition and consequent experience, relative to management experience, affects strategy selection. Clearly, this is an issue of managerial risk preference versus board power, so we also take into account the separation of CEO and chair roles. What we discover is that interaction effects do occur. The more outsiders there are on the board, the more likely it is managers will be pushed away from their comfort zone in strategy selection. The implication of this is that board monitoring and control in and of itself is insufficient to protect the interests of the principals. Instead, managing the relationship between board structure, leadership structure, and top-management-team experience is key to reducing agency problems.

Background and hypotheses

Examining interaction effects between the board and TMT is complex, so for the sake of methodological parsimony, we elected to focus on the strategy of late movers for our dependent variable. First movers are firms that gain technological leadership through radical or architectural innovations; gain control over scarce resources; and/or, manage to lock in customers (Lieberman and Montgomery, 1988). Such game-changing innovations create new industries, or at the least affect the structure of an existing industry, as does control over resources and customers. In any case, new or existing competitors end up following the leader. Like first movers, late movers can use a variety of business level strategies and tactics, but because their actions can be explained relative to the actions of first movers, our dependent variable reduces measurement and complexity issues. Late-mover strategy is described in terms of a continuum of resources ranging from those that are similar to those of first movers (imitation), to those which are different (substitution) (Geletkanycz and Hambrick, 1997; Yoo et al., 2009). Because of the ability of first movers to attract and secure economic rents, they have been the focus of much research attention. Less attention has been paid to the followers, even though they are more numerous. Although the focus of this work is on the interaction effects between the board and the TMT, an additional benefit of our research is that it helps redress the balance between research on first movers and late movers. In the following discussion, we start by briefly describing late-mover strategy before going on to develop our hypotheses on TMT strategic choice and board effects.

Late-mover strategies

First-mover advantage has been described in terms of its drivers (enablers), which include resources and capabilities, isolating mechanisms, and environmental factors such as the pace of market and technological evolution (Suarez and Lanzolla, 2007). Despite this, some late movers are able to replicate or surpass a first mover's advantage by copying its unique practices or technologies, or by finding a more effective or efficient way of organizing and coordinating productive activities. Thus, threats to first movers arise from the use of resource imitation and resource substitution by late movers (Yoo et al., 2009). Here, a resource – imitation strategy is defined as the reproduction or copying of a first mover's resources in order to duplicate their competencies. For example, Miller's and Coors's brewing skills allowed them to duplicate Rheingold's innovation of light beer; and, GE's production skills being comparable to EMI's meant GE was able to imitate and eventually overcome EMI's lead in CAT scanners (Haunschild, 1994; Hunt, 2000; Schnaars, 1994). By contrast, a resource – substitution strategy is defined as the use of alternative resources to circumvent first-mover competencies. According to Dierickx and Cool (1989), a successful resource substitution by late movers will render the original asset stocks of first movers obsolete — witness Canon's challenge to Xerox as a classic example of resource substitution, when Canon substituted quality-manufacturing skills for Xerox's extensive technical-service capabilities (Dierickx and Cool, 1989; Porter and Ishikura, 1983; McEvily et al., 2000).

TMT external ties and the strategic choice

The upper-echelons perspective emphasizes the attributes of top managers as a team, because strategic decisions are often made and implemented through dynamic processes wherein managers interact, consult and debate with each other (Cyert and March, 1963; Daily and Schwenk, 1996; March and Simon, 1958; Gioia and Chittipeddi, 1991; Woiceshyn, 2009). The perspective begins with the premise that strategic decisions are made under conditions of information overload and ambiguity. Drawing from behavioral decision-theory, Hambrick and Mason (1984) argued that top managers cope with the inherent complexity of strategic decision-making by referring to their pre-existing beliefs about appropriate strategic behavior, and that these scripts and schemas are shaped by prior experience (Hambrick and Mason, 1984). Furthermore, several studies suggest that boundary-spanning activities appear to influence pre-existing beliefs of top management, and thus impact the strategic decisions in firms (e.g., Geletkanycz and Hambrick, 1997; Haunschild, 1993). Research findings have shown that the external ties of top managers are an important means by which executives scan their business environment, and gain firsthand insight into other organizations' activities. But, in an attempt to economize on information search procedures, executives tend to rely on established channels to acquire information for insight into plausible alternatives.

We know that top managers exist in a social world, and that social embeddedness affects the major activities of firms and, as some recent research shows, it can have an effect on firm performance (Granovetter, 1988; Geletkanycz and Boyd, 2011).