Research Policy 43 (2014) 1800–1815

Contents lists available at ScienceDirect

Research Policy

journal homepage: www.elsevier.com/locate/respol

Outside directors on the board and innovative firm performance☆

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ARTICLE INFO

Article history:
Received 6 February 2013
Received in revised form 16 June 2014
Accepted 19 June 2014
Available online 11 July 2014

JEL classification:
G34
L14
L25
M21

Keywords:
Corporate governance
Innovation
Patents
Board composition
Outside directors

ABSTRACT

We investigate how outside directors on supervisory boards influence innovative activities of the firms they advise and monitor. Based on panel data on the largest German companies, the econometric analysis shows a positive influence of external executives on innovative firm performance, measured by patent applications. Differentiating between outside directors from innovative and non-innovative companies reveals that only outside directors from innovative firms increase patenting activities at the firms they advise and monitor. This effect increases with the technological proximity between the appointing firm and the outsider's home firm. Outside directors from non-innovative firms are negatively associated with the appointing firm's innovativeness. The results indicate that external executives with an appropriate professional background can provide valuable specific knowledge and expertise to the board.
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1. Introduction

Starting already with Knight and Schumpeter at the beginning of the 20th century, the literature on innovation has often highlighted the role of the entrepreneur. Although the existing findings are certainly still valid for owner-led firms, they are probably not applicable to the vast majority of large modern companies that are led by a team of managers instead (Czarnitzki and Kraft, 2009). Manager-led firms entail a classic principal–agent problem (Berle and Means, 1932; Williamson, 1964). As managers do not bear the full costs of their decisions, they presumably deviate from the value maximizing behavior to enhance their private benefits of control. This conflict of interest also arises in the context of innovative firm activities. Managers may not stimulate innovations up to the optimal extent to reduce the risk of failures (Aghion et al., 2013; Manso, 2011).

As switching to an owner-led firm is usually not an option for large companies, and size and complexity often demands a team of managers, the composition of the board of directors has a central role in corporate governance. In general, the literature strongly supports the importance of certain board characteristics for corporate governance (for an overview see e.g. Adams et al., 2010). Several studies analyze the role of outside directors on the board, particularly how outside directors on boards influence variables such as CEO remuneration (Coles et al., 2008; Denis and Sarin, 1999; Core et al., 1999), CEO appointments and dismissals (Borokhovich et al., 1996; Weisbach, 1988), adoption of antitakeover defenses (Brickley et al., 1994) or takeover premiums (Cotter et al., 1997; Byrd and Hickman, 1992). However, the relationship between outside directors and innovation, which

☆ The authors are grateful to three anonymous referees who helped to significantly improve the paper. Balsmeier gratefully acknowledges financial support from the Flemish Science Foundation.
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http://dx.doi.org/10.1016/j.respol.2014.06.003
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is a key driver of long run performance, has been almost completely neglected so far.

Theoretical predictions and empirical findings on the influence of outside directors on corporate performance are ambiguous. For instance, Fahlenbrach et al. (2010a) point out that external board mandates benefit the respective CEO directors personally but not the firms they monitor, while Fich (2005) reports positive abnormal stock returns on the announcement of new CEO director appointments. These findings are consistent with the different assessments of corporate networks via personal linkages of board members, which can be assessed either as an indication for enhanced monitoring and advising competences of the board or as a signal for director entrenchment and enhanced agency costs.

While the monitoring role of outside directors has been studied extensively, in recent years, the information and advising function of outside directors has been emphasized by a growing number of scholars recently (see e.g. Coles et al., 2012; Faleye et al., 2012; Field et al., 2013). Among other aspects, these authors highlight that outsiders on the board can improve the boards' advising quality by providing scarce specific knowledge and experience especially when firm operations are rather complex (e.g. Faleye et al., 2011; Coles et al., 2010). It has been noted, and empirically confirmed for outcome variables other than innovation, that managerial experience of board members is a crucial means of human capital provision (e.g. Kor and Sundaramurthy, 2009; Kor and Misangyi, 2008).

The present study sheds new light on this topic by examining the influence of outside directors on innovative firm performance, measured by patent applications. Drawing on a sample of large German firms covering the period from 2001 to 2008, our analysis reveals that external managers on supervisory boards have an economically meaningful and statistically significantly positive effect on patent applications of the firms they advise and monitor if the outside executives' home firms engage in relevant innovative activities themselves. This positive effect increases with the technological proximity between the connected firms. The results are in line with the perception that external managers provide scarce specific knowledge and experience to boards which improves the quality of the board's services. These additional competences may help firms to generate a higher number of innovations, e.g. by alleviating the identification of new market niches and products (Shane, 2000), the anticipation of technology and market development (Helfat and Lieberman, 2002), revealing promising and non-promising innovative projects (Weterings and Koster, 2007) or implementing incentive schemes that foster innovation efforts (Ederer and Manso, 2013).

The rest of the paper is organized as follows. In Section 2, we briefly summarize the literature related to outside directors on the board and innovation, discuss the theoretical background in more detail and develop our hypotheses. Section 3 deals with the compilation of the data set and presents descriptive statistics. In Section 4, we introduce our empirical methodology and our results on the relationship between outsiders on the board and patent applications. In Section 5, we review the main findings and discuss implications for management, policy makers and researchers.

2. Literature review and hypotheses development

2.1. Conceptual and institutional framework

The principal–agent relationship between shareholders and the management has received much attention in the corporate governance literature. This literature argues that managers have incentives and, due to asymmetric information, the opportunity to carry out projects that are not necessarily in line with shareholders' interests. In order to restrict the discretionary behavior of managers, shareholders of large modern companies assign a team of monitoring directors. Consequently, a vast and rapidly growing number of theoretical and empirical studies analyze how boards lessen or increase the manager–owner conflict. One of the most often analyzed board characteristic in this context are external managers serving as monitoring directors on other firms' boards (see e.g. Field et al., 2013; Fahlenbrach et al., 2010a, 2010b for recent contributions).

Agency relations are prevalent with one-tier as well as two-tiered boards. In contrast to firms with a monistic board structure, e.g. in the United States, executive and non-executive directors in German firms are organizationally separated. The management board members are responsible for the day-to-day operations, while the supervisory board members appoint, monitor and advise the executives. Two-tiered boards are commonly observed in several European member states. Among 371 firms that were listed on the largest stock exchanges in 13 European countries, 38% adhered to the dualistic system in the year 2008 (Heidrick and Struggles, 2009). Moreover, the two-tiered system becomes increasingly important against the background that all European firms can opt for a two-tiered board if they change their legal status to a European Company (Societas Europea, SE).

Given the institutional separation of active managers and supervising directors, external managerial knowledge provided by experienced outsiders might be particularly valuable on two-tiered boards. Information asymmetries between executives and monitoring board members on one-tier boards are typically lower which might lead to a different influence of outsiders in Anglo-Saxon institutional environments (Munari et al., 2010; Owen et al., 2006). In the present study, we focus on the case of Germany. Focusing on a single country has the advantage that the firms in our sample are exposed to the same national innovation system and a similar macroeconomic environment. The focus on firms with two-tiered board structures might limit, however, the external validity of our findings as firms operating in other institutional environments may experience different influences of outside managers (cf. Davis et al., 2012; Ferraro et al., 2012).

In the following subsection, we review previous theoretical considerations and empirical findings regarding the influence of outside directors on corporate governance, particularly concerning their monitoring capabilities and incentives. Subsequently, we will consider the relationship between outside directors on the board and firms' innovation activities.

2.2. The relevance of outside directors for firm performance

Board members with outside board memberships could affect corporate outcomes either positively or negatively. The literature has derived several arguments towards both perceptions, highlighting either the monitoring or the advising function of external board members.

It is sometimes argued that outsiders are more independent than other board members, because their personal future career does not depend on the professional advancement of their direct board colleagues and the CEO (Hermalin and Weisbach, 1998). Ferris et al. (2003) add that experienced outside directors on the board reflect more intensive monitoring and an increased reputation of the advising services provided (see also Fich, 2005). Masulis and Mobbs (2011) further show that firms with inside directors who have simultaneous outside board positions exhibit higher operating and stock-market performance compared to firms whose directors are not associated with other companies. The authors conclude that outside directorships help to reduce agency costs (see also Mobbs, 2013).

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