

# The relationship between the ownership structure and the role of the board

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## *Abstract*

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**Research Findings/Insights:** This study suggests that the ownership structure has an important influence on the priorities set by the board, and that these priorities will determine the optimal composition of the board of directors. In contrast to a board prioritizing monitoring, where directors with financial experience and a duality are important, a board prioritizing the provision of resources could benefit from directors with different characteristics, the presence of the CEO on the board of directors and a larger board size.

**Theoretical/Academic Implications:** Understanding the influence of the board of directors on firm performance requires greater sensitivity to how corporate governance affects different aspects of effectiveness for different stakeholders and in different contexts. The insights on the interaction between the ownership structure and board composition can shed new light onto the contradictory empirical results of past research that has tried to link board composition or structure to firm performance directly. In an effort to increase the relevance of future research on boards and firm performance, we provide a framework on the interaction between ownership, corporate boards and firm performance.

**Practitioner/Policy Implications:** In light of scandals and perceived advantages in reforming governance systems, debates have emerged over the appropriateness of implementing corporate governance recommendations mainly based on an Anglo–Saxon context characterized by dispersed ownership where markets for corporate control, legal regulation, and contractual incentives are key governance mechanisms. This paper adds to the literature that argues in favor of the need to adapt corporate governance policies to the local contexts of firms.

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# The relationship between the ownership structure and the role of the board

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## ABSTRACT

**Manuscript Type:** Conceptual

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**Key Words:** ownership structure, board of directors, monitoring, resource provision, firm performance

**JEL classification:** G3; G32; G34

## INTRODUCTION

Ownership structure is one of the main dimensions of corporate governance and is widely seen to be determined by other country-level corporate governance characteristics such as the development of the stock market and the nature of state intervention and regulation (La Porta, López-de-Silanes, Shleifer and Vishny, 1998). Shareholder structures are quite diverse across countries, with dispersed ownership being much more frequent in US and UK listed firms, compared to Continental Europe, where controlled ownership is prevalent (La Porta, López-de-Silanes, Shleifer and Vishny, 1999). Faccio and Lang (2002) report in a study of 5232 publicly traded corporations in 13 Western European countries that only 36.93 % were widely held firms. In addition, cross-country studies of La Porta *et al.* (1999) point out that ownership of large companies in rich economies is typically concentrated; that control is often exercised through pyramidal groups with a holding company at the top controlling one or more subsidiaries; and that the controlling shareholders are often actively involved in company management and sit on the board of directors. Although some companies in the United States are controlled by large shareholders, e.g. Microsoft, Ford, and Wal-Mart, such firms are relatively few and have thus drawn less attention in the corporate governance debate (Anderson and Reeb, 2003). The differences in ownership structure have two obvious consequences for corporate governance, as surveyed in Morck, Wolfenzon, and Yeung (2005). On the one hand, dominant shareholders have both the incentive and the power to discipline management. On the other hand, concentrated ownership can create conditions for a new problem, because the interests of controlling and minority shareholders are not aligned. We refer to Enrique and Volpin (2007) for a detailed description of the differences in the ownership structure of companies in the main economies of continental Europe with comparisons to the United States and the United Kingdom.

Corporate governance concerns “the structure of rights and responsibilities among the parties with a stake in the firm” (Aoki, 2001). Yet the diversity of practices around the world nearly defies a common definition (Aguilera and Jackson, 2003). In most comparisons, researchers contrast two dichotomous models of Anglo-American and Continental European corporate governance (Becht and Roël, 1999; Hall and Soskice, 2001; La Porta *et al.*, 1998). For example, the United Kingdom and United States are characterized by dispersed ownership where markets for corporate control, legal regulation, and contractual incentives are key governance mechanisms. In continental Europe and Japan, large shareholders such as banks

and families retain greater capacity to exercise direct control and, thus, operate in a context with fewer market-oriented rules for disclosure, weaker managerial incentives, and greater supply of debt. The predominant role of corporate governance reflected in the accounting and finance literature is the agency view (Fama and Jensen, 1983; Baysinger and Hoskisson, 1990; Bathala and Rao, 1995). While shareholders are concerned about maximizing returns at reasonable risk, managers may prefer growth to profits (empire building may bring prestige or higher salaries), may be lazy or fraudulent (“shirk”), and may maintain costly labor or product standards above the necessary competitive minimum. Given the potential separation of ownership and control (Berle and Means, 1932), various mechanisms are needed to align the interests of principals and agents (Fama, 1980; Fama and Jensen, 1983; Jensen and Meckling, 1976). Agency costs arise because shareholders face problems in monitoring management: they have imperfect information to make qualified decisions; contractual limits to management discretion may be difficult to enforce. To reduce these costs, various contractual mechanisms, including corporate boards, are designed to align the interests of the management with those of the stockholders (Shleifer and Vishny, 1997; Klein, 1998). Hence, monitoring the actions and decisions of management is the primary focus of the board from an agency perspective.

Boards are by definition the internal governing mechanism that shapes firm governance, given their direct access to the two other axes in the corporate governance triangle: managers and shareholders (owners). Fama (1980) argues that the composition of board structure is an important mechanism because the presence of non-executive directors represents a means of monitoring the actions of the executive directors and of ensuring that the executive directors are pursuing policies consistent with shareholders' interests. Furthermore, boards of directors are one of the centerpieces of corporate governance reform. In effect, the board of directors has emerged as both a target of blame for corporate misdeeds and as the source capable of improving corporate governance. Much of the weight in solving the excess power within corporations has been assigned to the board of directors and, specifically, to the need for non-executive directors to increase executive accountability. There are strong perceptions that independent directors lead to increased good governance (Fernández-Rodríguez, Gómez-Ansón and Cuervo-García, 2004). The high expectations of the role of the non-executive board members are interesting since the existing empirical studies show mixed results regarding the relationship between firm performance and board independence (e.g. Dalton,

Daily, Ellstrand and Johnson, 1998; Dulewicz and Herbert, 2004; Peng, 2004; Weisbach and Hermalin, 2003). In fact, some scholars argue that a supermajority of independent directors will lead to worse performance (Bhagat and Black, 1999). Furthermore, Hillman, Cannella and Paetzold (2000) discuss how in governance research there is a need to look at skills distinct from monitoring. They posit it is also important to have board members with varied skills such as being insiders in the firm, business experts, support specialists (e.g., experts on law or public relations) and community influentials (e.g., members of a community organization). The resource dependence perspective (Pfeffer and Salancik, 1978; Boyd, 1990) presents an alternative to the agency perspective, arguing that good governance is achieved when board members are appointed for their expertise to help firms successfully cope with environmental uncertainty.

Much of the policy prescriptions enshrined in codes of good corporate governance rely on universal notions of best practice, which often need to be adapted to the local contexts of firms or translated across diverse national institutional settings (Aguilera and Cuervo-Cazurra, 2004; Fiss and Zajac, 2004; Ahmadjian and Robbins, 2005). An important question addressed in this paper is whether all firms, regardless of their ownership pattern, should be submitted to the 'one-rule-fits-all' principle of majority non-executive directors and a separation of CEO and chairman. In this context, Aguilera (2005) and Millar, Eldomiaty, Choi and Hilton (2005) argue that national institutions such as the ownership structure, the enforceability of corporate regulations or culture tend to enable as well as constrain diverse corporate governance mechanisms and that a better understanding of the role of boards of directors in different institutional settings is needed before engaging in the debate of how to increase board accountability. Moreover, by providing a framework for analyzing how firms can address differences between the interests of principals (e.g., shareholders/board of directors) and agents (top managers), valuable contributions are made in assessing the efficient structure of corporate governance (Beatty and Zajac, 1994).

## **DUAL ROLE OF THE BOARD OF DIRECTORS**

Zahra and Pearce (1989) and Hillman and Dalziel (2003) describe the two main functions of the Board of Directors as monitoring and providing resources. The theoretical underpinning of the board's monitoring function is derived from agency theory, which describes the potential for conflicts of interest that arise from the separation of ownership and control in

organizations (Berle and Means, 1932; Fama and Jensen, 1983). Agency theorists see the primary function of boards as monitoring the actions of “agents”- managers - to protect the interests of “principals” -owners (Eisenhardt, 1989; Jensen and Meckling, 1976; Mizruchi, 1983). Monitoring by the board is important because of the potential costs incurred when management pursues its own interests at the expense of shareholders’ interests. Monitoring by boards of directors can reduce agency costs inherent in the separation of ownership and control and, in this way, improve firm performance (Fama, 1980; Mizruchi, 1983; Zahra and Pearce, 1989).

Researchers studying the monitoring function have coalesced in their general preference for boards dominated by independent outside directors (Barnhart, Marr and Rosenstein, 1994; Baysinger and Butler, 1985; Daily, 1995; Daily and Dalton, 1994a,b; Weisbach, 1988). They argue that boards consisting primarily of insiders (current or former managers/employees of the firm) or those outsiders who are not independent of current management or the firm (because of business dealings, family/social relationships) have less incentive to monitor management, owing to their dependence on the CEO/organization. Boards dominated by outside, nonaffiliated directors, however, are thought to be better monitors because they lack this disincentive to monitor. Despite numerous empirical tests, however, this hypothesis has yet to be unequivocally supported. Two recent meta-analyses of existing studies found no statistical support for a relationship between board incentives (e.g., board dependence or equity compensation) to monitor and firm performance (Dalton, Daily, Certo and Roengpitya, 2003; Dalton *et al.*, 1998).

The second, relatively less explored, path researchers take to study boards and firm performance relies on the provision of resources (e.g., legitimacy, advice and counsel, links to other organizations, etc.) by the board of directors. The theoretical underpinning of this approach is based on Pfeffer and Salancik’s (1978) work on resource dependency. This perspective is adopted by scholars in the resource dependence (Boyd, 1990; Daily and Dalton, 1994a,b; Gales and Kesner, 1994; Hillman *et al.*, 2000; Pfeffer, 1972; Pfeffer and Salancik, 1978) and stakeholder traditions (Hillman, Keim and Luce, 2001; Johnson and Greening, 1999; Luoma and Goodstein, 1999). Resources help reduce dependency between the organization and external contingencies (Pfeffer and Salancik, 1978), diminish uncertainty for the firm (Pfeffer, 1972), lower transaction costs (Williamson, 1984) and ultimately aid in the

survival of the firm (Singh, House and Tucker, 1986). Empirical studies in the resource dependence tradition have shown a relationship between board capital and firm performance (e.g., Boyd, 1990; Dalton, Daily, Johnson and Ellstrand, 1999; Pfeffer, 1972). Carpenter and Westphal (2001) found that boards consisting of directors with ties to strategically related organizations, for example, were able to provide better advice and counsel, which is positively related to firm performance (Westphal, 1999). In addition, Hillman, Zardkoohi and Bierman (1999) found that when directors established connections to the U.S. government, shareholder value was positively affected. They concluded that such connections held the promise for information flow, more open communication and/or potential influence with the government, a critical source of uncertainty for many firms. Researchers have also found that interlocking directorates can play an important role in disseminating information across firms (Burt, 1980; Palmer, 1983; Useem, 1984), in reducing vertical coordination and scanning costs (Bazerman and Schoorman, 1983), and in serving as a mechanism for the diffusion of innovation (Haunschild and Beckman, 1998). Executive directors' external ties also facilitate access to strategic information and opportunities (Pfeffer, 1991), enhance environmental scanning (Useem, 1984) and reveal information about the agendas and operations of other firms (Burt, 1983). Empirical evidence has shown that executives' external ties play a critical role in future strategy formulation and subsequent firm performance (Eisenhardt and Schoonhoven, 1996; Geletkanycz and Hambrick, 1997). Rosenstein and Wyatt (1994) have further shown, using event-study methodology, that shareholder value of a firm improves when the company's CEO is asked to join the board of another firm.

In practice, boards both monitor and provide resources (Korn/Ferry, 1999), and, theoretically, both are related to firm performance. A recent large scale archival study conducted by Larcker, Richardson and Tuna (2004) concluded that the traditional monitoring perspective of measuring governance is of limited value in explaining the behavior of managers as well as the performance of firms. Further, Cohen, Krishnamoorthy and Wright (2004) argue that a narrow view of corporate governance restricting it to only monitoring activities may potentially undervalue the role that corporate governance can play. However, the priorities of the board of directors are not independent from the context in which the company operates. Randøy and Jenssen (2004) argue that firms in highly competitive industries will already be 'monitored' by the market and, therefore, they should have fewer outside board members. In effect, they find a negative relationship between board independence and firm performance in

industries with highly competitive product markets among publicly traded Swedish firms and attributed the detrimental effect on the predominance of the director’s resource function over the monitoring function. Furthermore, previous literature indicates that agency problems that need to be addressed depend on the ownership structure. The monitoring role of outside directors is most important when ownership is diffuse: when ownership is concentrated, the large shareholder(s) can effectively influence and monitor the management, sometimes by personally sitting on the board. Shleifer and Vishny (1986) argue that large shareholders have a strong incentive to monitor managers because of their significant economic stakes. Even when they cannot monitor the management themselves, large shareholders can facilitate third-party takeovers by splitting the large gains on their own shares with the bidder. In a corporation with many small owners, however, it may not pay any one of them to monitor the performance of the management individually.

The demand for monitoring is expected to be influenced by the distribution of power amongst the stakeholders and their individual incentives. The agency literature suggests that some control mechanisms may be substitutable so that there could be a trade-off among various sources of control available to individual stakeholders (Jensen and Meckling, 1976). Considering two essential dimensions of the ownership structure, concentration and managerial ownership, we describe the main corporate governance problems and main role of the board of directors (table 1).

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**1) Dispersed ownership – none or low managerial ownership**

In firms with dispersed ownership the main agency conflict to be addressed is the conflict between hired managers who are unaccountable to outsiders and dispersed shareholders due to the separation of ownership and control (Jensen and Meckling, 1976). The dispersed ownership structures of large companies could potentially generate free rider problems insofar as they hinder direct managerial supervision by shareholders (Grossman and Hart, 1980). Shareholders in firms with dispersed ownership prefer strategies of exit rather than voice to

monitor management (Eisenhardt, 1989). While small shareholders do not have incentive to monitor individually, collectively all shareholders benefit from the monitoring efforts by the board of directors. Therefore, the function of the board of directors is likely to focus on monitoring management to reduce the agency problems between management and dispersed shareholders.

## **2) Dispersed ownership – some managerial ownership**

Managerial stock ownership contributes to reducing agency costs (Jensen and Meckling, 1976). When a company's managers hold a substantial number of the shares of that company, there is an alignment of interests between the managers and the rest of the shareholders. Managers benefit directly from their own professional efforts and suffer the negative consequences of their opportunistic actions through the respective positive and negative variations of the market value of their shares. The board of directors remains the main instrument of monitoring of shareholders but the agency problem may be less severe when managers hold relative important shareholder positions.

## **3) Controlled ownership – none or low managerial ownership**

Shleifer and Vishny (1986) argue that large shareholders have a strong incentive to monitor managers because of their significant economic stakes. Furthermore, large shareholder typically has some ability to influence proxy voting and may also receive special attention from management (Useem, 1996). Moreover, Heflin and Shaw (2000) argue that monitoring by large shareholders might give them access to 'private, value-relevant information. These shareholders can also engage with management in setting corporate policy (Bhagat, Black and Blair, 2004). Fernández Méndez and Arrondo García (2007) find evidence of a negative effect of large shareholders on audit committee activity, possibly as a result of substitution between alternative control mechanisms or because of large shareholder exploitation of private benefits of control. Furthermore, large shareholders are in the position to facilitate third-party takeovers by splitting the large gains on their own shares with the bidder (shleifer and Vishny, 1986). For firms with controlling shareholders, however, separation of ownership and control generates a two-level agency problem: between controlling shareholders and management and between minority shareholders and controlling shareholders. The problem between controlling shareholders and minority shareholders will be less severe if management is independent from the controlling shareholders.

The board of directors reflects to a high degree the shareholder structure of the company. Large shareholders are typically directly or indirectly represented on the board of directors. Prioritizing the monitoring activity, over the provision of resources, of the board of directors benefits mostly minority shareholders, while large shareholders already dedicate individual efforts to monitoring and have access to superior information, management interaction and alternative governance mechanisms to discipline management. Furthermore, minority shareholders have less influence on the board composition compared to large shareholders. Therefore, the priorities of the board may be directed towards the provision of resources rather than adding an additional layer of monitoring.

#### **4) Controlled ownership – some managerial ownership**

When the controlling shareholders are also actively involved in the management of the company, the agency problem related to the dispersion of ownership and control is dissolved. However, another agency problem, that between minority shareholders and controlling shareholders, may arise. A recent example of this problem was presented by the Parmalat scandal, where the controlling shareholder and CEO, Calisto Tanzi diverted about \$800m shareholder's wealth towards family controlled businesses. Family firms are typically characterized by large controlling owners who are actively involved in management and have recently received a lot of attention from research. As mentioned before, the board of directors typically reflects at least partially the ownership structure. Therefore, a board where the controlling family has an overwhelming influence on the board of directors and control the information provided to its members is less likely to provide good monitoring. Empirical studies however show that these firms do not underperform.

Previous studies suggest that family owners may have superior monitoring abilities relative to diffused shareholders, especially when family ownership is combined with family control over management and the board (Anderson and Reeb, 2004). Because current generation owners have the tendency and obligation to preserve wealth for the next generation, family firms often have longer time horizons compared to nonfamily firms. Moreover, the controlling family is likely to commit more human capital to the firm and to care more about its long-run value (Bertrand and Schoar, 2006). Family members therefore represent a special

class of large shareholders that may have a unique incentive structure, a strong voice in the firm and powerful motivation to make longer term strategic decisions (Becht and Roel, 1999; Dhnadirek and Tang, 2003). The monitoring happens however largely beyond the board of directors. Jensen and Meckling's (1976) agency model asserts that family firms have so little managerial opportunism within their organizational structure that the need for internal governance mechanisms, like a board of directors, is negated. Recent theory suggests, however, that boards serve more than a governance function (e.g., Hillman and Dalziel, 2003; Johnson, Daily and Ellstrand, 1996). In this more recent tradition, we perceive the board of directors as a resource used by family firm owners to assist family executives (less so than to monitor them).

Recent studies confirm that, on average, family-controlled firms are better managed than widely held ones. In a sample of large U.S. companies, Anderson and Reeb (2003) find a significantly higher Tobin's  $q$  for family-controlled firms (a third of their sample) than for widely held companies. Barontini and Caprio (2005) find a similar result for European companies. Tobin's  $q$  is the ratio of the market value of a firm to the replacement value of its assets, typically measured as the book value of the firm's assets. A higher (industry-adjusted) Tobin's  $q$  suggests that the assets are used efficiently—that is, they are worth more within the firm than in alternative uses.

However, families, like managers in a widely held company, can abuse their power and use corporate resources to their own advantage. When this happens in a family-controlled firm, things are even worse than in a widely held company, because controlling families cannot be ousted through a hostile takeover or replaced by the board of directors or by the shareholders' meeting (Enrique and Volpin, 2007). Research on deterrence of expropriation mainly focuses mainly on the presence of other large institutional shareholders or institutional regulation to control such behavior, rather than focusing on the composition of the board of directors.

## **OWNERSHIP STRUCTURE AND BOARD COMPOSITION: SETTING PRIORITIES**

Agency theory explains how agency problems depend on the ownership structure: on the one hand, firms with dispersed ownership face agency problems between management and dispersed shareholders, as described by Berle and Means (1932). Shareholders with a little

stake in the firm has weak incentives to engage in monitoring of managers since all the costs of monitoring are incurred while only a small fraction of the benefits are gained (the typical free rider problem). To resolve the alignment problem in firms with dispersed ownership, the board primary focuses on monitoring. On the other hand, firms with large controlling owners largely solve the management-shareholders agency problem. The composition and role of the board of directors can be influenced by large shareholders in the general shareholders meeting. Rather than using the board to add an additional layer of monitoring, a role as providing resource to management maybe much more useful to improve firm performance. Hillman and Dalziel (2003) argue that both ability and incentives of stakeholders are likely to affect behavior within organizations, suggesting that examining one without the other is insufficient.

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Insert Figure 1 about here  
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From the previous discussion it is clear that the ownership structure may influence the composition and role of the board of directors, as shown in figure 1. Shareholders in firms with dispersed ownership have, collectively, a great need to use the board of directors to monitor the managers, while large shareholders in firms with concentrated ownership are individually motivated to monitor management, have a lot of influence beyond the board, access to valuable information and alternative corporate governance mechanisms to discipline the managers if necessary. Furthermore, if the controlling owners are also actively involved in the management of the company, the need to monitor by the controlling shareholder disappears. Fernández Méndez and Arrondo García (2007) provide empirical evidence in this context. They find a lower audit committee’s activity in highly leveraged firms and when the ownership structure is concentrated in the hands of large shareholders.

*Proposition 1a: The board of directors in companies with dispersed ownership focuses primarily on monitoring*

*Proposition 1b: The board of directors in companies with concentrated ownership focuses primarily on providing resources*

## **THE CHARACTERISTICS OF OUTSIDE DIRECTORS**

Boards are by definition the internal governing mechanism that shapes firm governance, given their direct access to the two other axes in the corporate governance triangle: managers and shareholders (owners). Furthermore, the board of directors has emerged as both a target of blame for corporate misdeeds and as the source capable of improving corporate governance. Much of the weight in solving the excess (generally executive) power within corporations has been assigned to the board of directors and, specifically, to the need for non-executive directors to increase executive accountability.

Agency theorists argue that the composition of board structure is an important mechanism because the presence of non-executive directors represents a means of monitoring the actions of the executive directors and of ensuring that the executive directors are pursuing policies consistent with shareholders' interests (Fama, 1980). However, from a resource provision point of view outsiders can bring in important knowledge, including providing legitimacy/bolstering the public image of the firm, providing expertise, administering advice and counsel, linking the firm to important stakeholders or other important entities, facilitating access to resources such as capital, building external relations, diffusing innovation and aiding in the formulation of strategy or other important firm decisions. Therefore, from both perspectives bringing outsiders to the board may improve firm performance. However the desired characteristics of the outside board members are different for a board focusing on monitoring compared to a board focusing on providing resources. For the first, financial expertise may be the most important element, while knowledge of the industry, competitors, law or other relevant resources may be more important for the latter.

The many empirical studies that have examined the impact of the insider-outsider ratio on boards have found no consistent evidence to suggest that increasing the percentage of outsiders on the board will enhance performance. If anything, they suggest that pushing too far to remove inside and affiliated directors may harm firm performance by depriving boards of the valuable firm and industry-specific knowledge they provide (Fama and Jensen, 1983; Baysinger and Hoskisson, 1990). A few studies identified a positive relationship between the percentage of outside directors and firm performance (Schellenger, Wood and Tashakori, 1989; Pearce and Zahra, 1992; Daily and Dalton, 1993), while other studies found no significant relationship between board composition and company performance (Mallette and

Fowler, 1992; Daily and Johnson, 1997; Bhagat and Black, 1999; Hermalin and Weisbach, 1991; Klein, 1998; Dulewicz and Herbert, 2004).

Trying to explain these conflicting findings, Dalton *et al.* (1998) and Wagner, Stimpert and Fubara (1998) conducted meta-analyses of the research on board composition and performance. Dalton *et al.*'s (1998) analysis of 54 studies found no evidence of a link between insider-outsider ratio and company financial performance and showed that neither the size of the company nor the measures used for director type or company performance, affected the findings. Wagner *et al.* (1998) analyzed 29 studies and found similar results, with their meta-analysis indicating that increasing the number of insiders or outsiders had a positive effect on performance, suggesting that board size may be more important than composition. They also found some evidence of a U-shaped relationship between the insider-outsider ratio and performance, as boards with a very high or low percentage of insiders performed better than those with a more even mix of insiders and outsiders. In contrast, Barnhart *et al.* (1994) and Barnhart and Rosenstein (1998) found evidence of a reverse, curvilinear relationship between the percentage of independent directors, as classified by Institutional Shareholder Services (ISS), and some performance measures. They reported that firms where boards have a clear majority of independent directors or very few independent directors had lower stock market performance.

Recently, Peng (2004) analyzed a sample of China's largest public companies and found that increasing the percentage of independent directors had no impact on either ROE or sales growth, but that adding more affiliated, outside directors, was linked to higher subsequent sales growth (but not ROE). He attributes this result to the role these directors play in securing resources for the firm as part of Chinese business networks.

The desired characteristics of the outside board members may depend on the priorities set by the board of directors. Boards primarily focusing on monitoring can benefit strongly from outside board members who have expertise at understanding financial reports, while boards focusing on providing resources may benefit from having politicians or lawyers on their boards. Additionally, corporate governance codes have strongly focused on board independence as key element of good governance. It is a priori not clear whether boards

focusing on resource provision would have a smaller ratio of insiders/outside on the board, as they have a clear interest in bringing outsiders to the board as well.

*Proposition 2a: There is a positive relationship between the proportion of board members with financial monitoring expertise and firm performance when the board focuses on monitoring.*

*Proposition 2b: There is a positive relationship between the proportion of board members who provide resources to the company and firm performance when the board focuses on providing resources.*

### **CEO-CHAIRMAN DUALITY**

Board composition is a fundamental characteristic that affects the board's capacity to control managerial actions (Fama and Jensen, 1983). A manager-dominated board has severe limitations as far as controlling managerial actions contrary to shareholders' interests is concerned. Consequently, a manager-dominated board would not be an effective way to control managers' opportunistic actions. The reason is that when the CEO is also the chairman of the board, the power within the firm is concentrated in one person's hands. This allows the CEO to control information available to other board members. The board becomes under the control of managers, which prevents it from effectively accomplishing its tasks of hiring, eventually firing, and rewarding top executive officers, and to ratify and monitor important decisions. Given the decrease in the effectiveness of the board the potential agency costs resulting from the separation of ownership and decision making are exacerbated. Jensen (1993) recommends that companies separate the titles of CEO and board chairman. Furthermore, dominance of a board by insiders could hinder the formation of active, independent audit committees (Klein, 2002).

The results of research on the effects of duality on company performance are ambiguous (Finegold, Benson and Hecht, 2007). Most studies using stock market measures have found no significant effects (Daily and Dalton, 1992, 1997; Rechner and Dalton, 1989; Baliga *et al.*, 1996; Brickley *et al.*, 1997). Studies that have looked at financial measures have shown mixed results with some indicating that duality enhanced performance (Daily and Dalton, 1994;

Donaldson and Davis, 1991; Kiel and Nicholson, 2003), while others (Coles, McWilliams and Sen, 2001; Rechner and Dalton, 1991) showed negative impact.

Finkelstein and D'Aveni (1994) present a contingency model which suggests independent board structure is beneficial when the firm has been experiencing strong financial performance, and there is increased potential for entrenchment. Rhoades, Rechner and Sundaramurthy (2001) found empirical support using a meta-analysis of 22 duality studies. Furthermore, Boyd (1995) found that in industries that were resource-constrained or higher in complexity having one person fill both roles was positively related to return on investment (ROI), while overall duality was not significantly related to ROI. A study of Chinese companies (Peng, 2004) making the difficult transition from state-owned enterprises to publicly-traded joint stock companies also found that firms with a unified chair-CEO had higher sales growth (but not ROE).

From an agency perspective, a duality of the chairman may substantially weaken the board's monitoring effectiveness. However from a resource provision perspective, a duality may be beneficial. If the board of directors is designed to assist management, the presence of CEO on the board will be beneficial. Not only will its presence improve the information flow towards the board members, but the interaction and discussion of the CEO with board members may lead to more valuable advice and better firm performance. Furthermore, the problem of duality may be far less relevant when large shareholders provide counterbalance. An underperforming CEO, even if chairman, may face more initiative to substitute him by board members representing large shareholders than board members representing minority shareholders.

*Proposition 3a: There is a negative relationship between the duality and firm performance when the board focuses on monitoring.*

*Proposition 3a: There is a positive relationship between the duality and firm performance when the board focuses on providing resources.*

## **BOARD OF DIRECTOR'S OPTIMAL SIZE**

Previous literature has studied the relationship between the number of directors sitting on the board and firm performance. Different and opposing theoretical arguments are presented in the literature to support either large or small board size. Large board size is argued to benefit corporate performance as a result of enhancing the ability of the firm to establish external links with the environment, securing more rare resources and bringing more exceptional qualified counsel (Dalton *et al.*, 1999). In other words, “the greater the need for effective external linkage, the larger the board should be” (Pfeffer and Salancik 1978: 172). Furthermore, large board size may improve the efficiency of decision making process as a result of information sharing (Lehn, Sukesh and Zhao, 2003). On the other hand, Jensen (1993) states that keeping boards small can help improve their performance. When boards get beyond seven or eight people they are less likely to function effectively and are easier for the CEO to control. This leans on the idea that communication, coordination of tasks and decision making effectiveness among a large group of people is harder and costlier than it is in smaller groups. The costs overwhelm the advantages gained from having more people to draw on.

There has been relatively little empirical research directly focused on the impact of board size on performance that could help determine the validity of these two perspectives. Yermack (1996), Bohren and Odegarrd (2001) and Postma, Van Ees and Sterken (2003) found firms with smaller boards have a better performance. Other authors offered supportive evidence for the positive influence of large board size (Dalton *et al.*, 1999; Kiel and Nicholson, 2003; Bozec and Dia, 2007; Belkhir, 2009). Moreover, other scholars have revealed no relationship between board size and corporate performance (Kaymark and Bekats, 2008). Finally, Eisenberg, Sundgren and Wells (1998) showed companies with smaller boards had higher ROA for 879 Finnish firms, arguing that the impact of board size may in part be contingent on the size and health of the firm.

Dalton *et al.* (1999) conducted a meta-analysis of 27 studies that featured a board size variable and found having more directors was associated with higher levels of firm financial performance. This result held true for firms of all sizes, but the effect of board size on performance was greater for smaller firms. In contrast, De Andres, Azofra and Lopez (2005) analyzed ten developed markets, including the United States, and found a negative relationship between board size and firm performance as measured by 12-month equity

market-to-book value, although the convex patterns of results suggested negative impact decreased as board sizes were larger.

Considering the different a board can set, it is not clear whether the board size of boards focusing on monitoring would have exactly the same optima size as boards focusing on providing resources. Especially the incentives and ability of controlling a board focusing on providing resources by the CEO will be much lower. Therefore, the optimal board size for boards focusing on providing resources rather than monitoring may be somewhat larger.

*Proposition 4: The optimal board size is larger for boards prioritizing provision of resources than for boards prioritizing monitoring.*

### **INFLUENCE OF CORPORATE GOVERNANCE POLICIES**

Codes of good governance have risen to prominence in the last decade as they have spread around the world (Aguilera and Cuervo-Cazurra, 2009). Codes of good governance have some key universal principles for effective corporate governance which are common to most countries. O'Shea (2005) shows that most codes have some recommendations on the following six governance practices explicitly or implicitly: (1) A balance of executive and non-executive directors, such as independent non-executive directors; (2) a clear division of responsibilities between the chairman and the chief executive officer; (3) the need for timely and quality information provided to the board; (4) formal and transparent procedures for the appointment of new directors; (5) balanced and understandable financial reporting; and (6) maintenance of a sound system of internal control.

One mechanism to implement codes is through development of stringent corporate legislation. However, such a compulsory approach is rarely found in codes of good governance and is more commonly associated with laws and regulations. Voluntary firm compliance is the other mechanism used to implement the codes as it was originally done in the Cadbury Report. It is based on the rule of "comply or explain" where it is not required for listed companies to comply with the all code recommendations, but companies are required to state how they have applied the principles in the code and in the cases of noncompliance, they must explain the reasons. According to MacNeil and Li (2006), this approach has two underlying

considerations: flexibility to adjust the characteristics of different firms and an assumption that the capital markets will monitor and assess value to compliance. Goncharov, Werner and Zimmermann (2006) show that there the degree of compliance with the code is the consistent value-relevant information for the capital market. Firms with higher compliance are priced at an average premium. This suggests that the capital markets accept the rules of the code to be meaningful and there is capital market pressure to adopt the code. Pressure to comply with corporate governance codes could have a moderating effect on the design of the board of directors.

*Proposition 5: Corporate governance policies and capital market pressure to comply with corporate governance policies may influence the board composition decisions.*

## **DISCUSSION AND POLICY IMPLICATIONS**

Our framework has highlighted the importance of different organizational environments on the board of directors. Much corporate governance research focuses on an Anglo-Saxon context, the results of which may be hard to generalize across different samples of firms or national systems. In addition, much of the policy prescriptions enshrined in codes of good corporate governance rely on universal notions of best practice, which often need to be adapted to the local contexts of firms or translated across diverse national institutional settings (Aguilera and Cuervo-Cazurra 2004, Fiss and Zajac 2004). In this context, Aguilera (2005) and Millar *et al.* (2005) argue that national institutions such as the ownership structure, the enforceability of corporate regulations or culture tend to enable as well as constrain diverse corporate governance mechanisms and that a better understanding of the role of boards of directors in different institutional settings is needed before engaging in the debate of how to increase board accountability. An important question addressed in this paper is whether all firms, regardless of their ownership pattern, should be submitted to the ‘one-rule-fits-all’ principle of majority non-executive directors, a separation of CEO and chairman and the optimal board size.

Furthermore, much of the weight in solving the excess power within corporations has been assigned to the board of directors and, specifically, to the need for non-executive directors to increase executive accountability. The high expectations of the role of the non-executive

board members are interesting since the existing empirical studies show mixed results regarding the relationship between firm performance and board independence. Hillman *et al.* (2000) discuss how in governance research there is a need to look at skills distinct from monitoring. They posit it is also important to have board members with varied skills such as being insiders in the firm, business experts, support specialists (e.g., experts on law or public relations) and community influentials (e.g., members of a community organization). Moreover, the resource dependence perspective presents an alternative to the agency perspective, arguing that good governance is achieved when board members are appointed for their expertise to help firms successfully cope with environmental uncertainty.

Zahra and Pearce (1989) and Hillman and Dalziel (2003) describe the two main functions of the Board of Directors as monitoring and providing resources. In practice, boards both monitor and provide resources (Korn/Ferry, 1999), and, theoretically, both are related to firm performance. We argue that the priorities of the board of directors are not independent from the context in which the company operates. The monitoring role of outside directors is most important when ownership is diffuse: when ownership is concentrated, the large shareholder(s) can effectively influence and monitor the management, sometimes by personally sitting on the board. Shleifer and Vishny (1986) argue that large shareholders have a strong incentive to monitor managers because of their significant economic stakes. Furthermore, the composition and role of the board of directors can be influenced by large shareholders. Rather than using the board to add an additional layer of monitoring, a role as providing resource to management maybe much more useful to improve firm performance. Large shareholders in firms with concentrated ownership are individually motivated to monitor management, have a lot of influence beyond the board, access to valuable information and alternative corporate governance mechanisms to discipline the managers if necessary. Furthermore, if the controlling owners are also actively involved in the management of the company, the need to monitor by the controlling shareholder disappears. However, shareholders in firms with dispersed ownership have, collectively, a great need to use the board of directors to monitor the managers to resolve the alignment problem.

We argue that the desired characteristics of the outside board members depend on the priorities set by the board of directors. Board primarily focusing on monitoring can benefit strongly from outsider board members who have expertise and experience at understanding

financial reports, while boards focusing on providing resources may benefit from having politicians or lawyers on their boards. Additionally, corporate governance codes have strongly focused on board independence as key element of good governance. From an agency perspective, a duality of the chairman may substantially weaken the board's monitoring effectiveness. However from a resource provision perspective, a duality may be beneficial. If the board of directors is designed to assist management, the presence of CEO on the board will be beneficial. Not only will its presence improve the information flow towards the board members, but the interaction and discussion of the CEO with board members may lead to more valuable advice and better firm performance. Furthermore, the problem of duality may be far less relevant when large shareholders provide counterbalance. An underperforming CEO, even if chairman, may face more initiative to substitute him by board members representing large shareholders than board members representing minority shareholders.

Understanding the influence of the board of directors on firm performance requires greater sensitivity to how corporate governance affects different aspects of effectiveness for different stakeholders and in different contexts. We argue that theory and empirical research should progress to a more context dependent understanding of corporate governance and that this, in turn, will prove very useful for practitioners and policymakers interested in applying corporate governance in particular situations.

The insight on the interaction between the ownership structure and board composition can shed new light onto the contradictory empirical results of past research that has tried to link board composition or structure to firm performance directly. For example, the question of whether CEO and chairman separation fosters firm performance or not has remained unanswered. A closer look at the interactions between the shareholders structure and the boards' priorities may then help us to better understand why, in some instances, duality is associated with better firm performance, and in others it is not. The argument for a more contextualized approach to corporate governance has implications for public policy. In light of scandals and perceived advantages in reforming governance systems, debates have emerged over the appropriateness of implementing corporate governance recommendations mainly based on an Anglo-Saxon context characterized by dispersed ownership where markets for corporate control, legal regulation, and contractual incentives are key governance mechanisms.

## CONCLUSION

This paper develops a theoretical model to better understand how the priorities of the board of directors are influenced by the ownership structure and how that affects firm performance. Most corporate governance research focuses on a universal link between corporate governance practices (e.g., board structure, shareholder activism) and performance outcomes, but neglects how the specific context of each company and diverse environments lead to variations in the effectiveness of different governance practices. Furthermore, the corporate governance reforms focus strongly on improving the monitoring ability of the board of directors. However, the resource dependence perspective (Pfeffer and Salancik 1978; Boyd 1990) presents an alternative to the agency perspective, arguing that good governance is achieved when board members provide valuable resources to help firms successfully cope with environmental uncertainty rather than monitoring experience. This study suggest that the ownership structure has an important influence on the priorities set by the board, and that these priorities will determine the optimal composition of the board of directors. In contrast to a board prioritizing monitoring, where directors with financial experience and a duality are important, a board prioritizing the provision of resources could benefit from directors with different characteristics, the presence of the CEO on the board of directors and a larger board size.

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**Table1: Ownership, Corporate governance problems and the priorities of the board**

	None or low Managerial ownership	Some Managerial ownership
Firms with Dispersed ownership	<p>1) Important Management – Shareholders agency problem: individual shareholders are concerned that management pursues its own utility maximization at the stake of firm value, but each Shareholder lacks incentive to monitor individually (free-riding problem)</p> <p><u>Board of Directors</u>: main task is to monitor management and align management actions with shareholders’ interests.</p> <p><u>Alternatively</u>: Market for managers, Take-over threat</p> <ul style="list-style-type: none"> <li>➤ <u>Monitoring priority of the board: very high</u></li> <li>➤ <u>Provision of Resources: moderate</u></li> </ul>	<p>2) Important Management – Shareholders agency problem: individual shareholders are concerned that management pursues its own utility maximization at the stake of firm value, but the problem is reduced by incentive alignment</p> <p><u>Board of Directors</u>: main task is to monitor management and align management actions with shareholders’ interests.</p> <p><u>Alternatively</u>: Market for managers, Take-over threat</p> <ul style="list-style-type: none"> <li>➤ <u>Monitoring priority of the board: high</u></li> <li>➤ <u>Provision of Resources: moderate</u></li> </ul>
Firms with controlled ownership	<p>3) Lesser management – shareholder agency problem: Large shareholder(s) provide monitoring of management, and the presence of outside shareholders reduces the risk of wealth expropriation from minority shareholders.</p> <p><u>Board of Directors</u>: reflects to a large extend the ownerships structure and since large shareholders already monitor management, providing useful resources to management rather than focusing extensively on monitoring may be a more valuable option.</p> <p><u>Alternatively</u>: the presence of other block holders could limit minority expropriation behavior</p> <ul style="list-style-type: none"> <li>➤ <u>Monitoring priority of the board: low</u></li> <li>➤ <u>Provision of Resources: high</u></li> </ul>	<p>4) No management – shareholder agency problem, but risk of wealth expropriation from minority shareholders (e.g.Family controlled firms )</p> <p><u>Board of Directors</u>: reflects to a large extend the ownerships structure and since large shareholders are also managers, providing useful resources to management may be a more valuable option.</p> <p><u>Alternatively</u>: the presence of other block holders could limit minority expropriation behavior</p> <ul style="list-style-type: none"> <li>➤ <u>Monitoring priority of the board: very low</u></li> <li>➤ <u>Provision of Resources: very high</u></li> </ul>

**Figure 1: relationship between ownership structure, composition of the board and firm performance**

