The Relationship of the Internal versus External Orientations of Non-Executive Directors to the Execution of Board Roles: A Framework for Board Analysis

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Abstract

"…[A director's] independence…[is] not nearly as important as a director's competence…" (Leblanc 2004). The view of the Canadian board researcher points to the growing consensus that the structural focus of research into boards does not provide complete answers to the question of what makes for an effective board. The process oriented board research perspective has increasingly recognized that directors, and non-executive directors in particular, need to possess relevant competences if they are to be effective. What is lacking, however, is an analytical framework that will assist researchers in identifying and classifying those competences which make a director effective. Through the theoretical lenses of the resource based view, the upper echelons perspective, and human capital theory, this paper proposes a framework by which the contribution of non-executive directors can be evaluated. The paper also underlines the importance of contingency effects in defining when certain director competences are most useful to the firm, and points in particular to the importance of industry life cycle as a contingent variable. Furthermore, the perspective presented here provides for the possibility that the non-executive director contributes to the firm not only as a monitor or boundary spanner, but as a competent actor, capable of detailed firm knowledge, who can contribute to the elaboration and successful implementation of firm strategy.

Key words: corporate governance, boards of directors, non-executive directors, competence based perspective

"…[A director's] independence…[is] not nearly as important as a director's competence…"

- Richard Leblanc (2004)

I. Introduction

The past decade has seen business failures in many parts of the world which have turned the focus of investors, governments, and the general public to questions of corporate governance. The names of Enron, WorldCom Inc. and Global Crossing have become synonymous with corporate malfeasance, and with the efforts of some corporate elites to deceive their own stakeholders and the public at large. The result has been a perceived crisis in corporate governance, with understandable calls for reforms in the structures and systems of corporate governance.

In the United States, for example, market watchdogs such as the SEC, as well as the US Congress, have implemented reforms to corporate governance systems in an attempt to make the deliberations of corporate elites more transparent, and the elites themselves more accountable for their actions. The Sarbanes-Oxley Act of 2002, as well as changes in corporate governance rules adopted by the New York Stock Exchange (NYSE), the National Association of Securities Dealers (NASD), and the American Stock Exchange (AMEX), has endeavoured to protect the investing public by requiring corporate disclosures of information to be more reliable and accurate. Many of the reforms implemented by these bodies have also focused on boards of directors in general, and on Non-Executive Directors (NEDs) in particular, as those individuals in the corporate hierarchy best positioned to monitor the actions of managers. The Sarbanes-Oxley Act of 2002 went so far as to require listed companies to maintain boards of directors comprised of a majority of NEDs.

This focus on boards of directors and on NEDs in the public eye has also led to an increase in academic research dealing with this seemingly powerful, yet difficult to scrutinize, institution of corporate governance. Recently, academic research has examined the board of directors more closely in order to ascertain its impact on the firm and on its performance. The question of the impact of the board of directors has been among the most difficult to answer in corporate governance research, and much of the research that has been done concerning the influence of the board has been inconclusive.

This inconclusiveness regarding the impact of the board rightly obliges us to look even more closely at not only the board itself, but also at those individuals who sit on it. Structure focused board research has been complemented by process focused board research in an effort to get inside the “black box” that is the modern corporate board. The inconclusiveness of much board research may be attributable to the fact that it focuses more on the structure of the board than on the background, experiences, and competences of those individuals who actually sit on the board. Recent research, furthermore, has tended to examine boards in something of a vacuum, without taking into consideration the full range of contextual factors that might themselves influence the impact of the board on the firm’s performance, such as the roles that the board is supposed to fulfil, as well as the impact of industry conditions on the fulfilment of those roles.

Scholars and practitioners have increasingly underlined the need for “competent directors”, without clearly spelling out which competences are required in order for directors, and boards, to be effective. The above mentioned corporate scandals have served to place a perhaps exaggerated emphasis on the monitoring role of NEDs, and this has tended to obscure the true value of the NED to the board, as well as the role that he or she fulfils.

Much research concerning boards tends to take place through the lens of one board activity rather than through a more comprehensive role set. Much research concerning NEDs emphasizes their role as monitors, but does not broach the question of what competences the NED must have in order to be a good monitor. In addition, little research has been undertaken to determine which types of competences permit NEDs to be effective in the fulfilment of other board roles, such as strategy, and, advice & counsel. In addition to emphasizing the NED’s monitoring role, some scholars and practitioners have often emphasized the fact that NEDs add value to the firm by serving as boundary spanners, linking the firm to its outside environment. Surprisingly little research has examined NEDs as internal firm resources in their own right, focused more on firm management and strategy than on boundary spanning activities.

In this article I shall develop a framework of analysis for the impact of NEDs on the firms that they serve, not through the lens of a single role, such as “monitoring”, or “boundary spanning”, seen in isolation. It will seek, rather, to present a framework for the impact of NEDs on the execution of a set of roles covering a more comprehensive range of board activities. In this article I shall attempt to show that the overall impact of the NED on the firm is demonstrated, not by ratios of “independence” on the board of directors, but rather by the orientation of NEDs as expressed through the competencies that they bring to the board.

II. Analytical Framework

As mentioned above, examples of corporate malfeasance over the past decade have focused the attention of the general public on questions of corporate governance in general, and on boards of directors in particular. The business press has covered corporate scandals (Lavelle 2002; Nussbaum 2002) and scholars have discussed the governance implications for boards of directors (Aguilera 2005; Tricker 2000). From the early 1990’s until today, in the UK, the US, and elsewhere, market watchdogs have established norms and guidelines regarding boards of directors that have largely called for increased numbers of independent directors on boards (Committee on the Financial Aspects of Corporate Governance 1992; Securities and Exchange Commission 2003). The United States Congress passed legislation in 2002, the Sarbanes-Oxley Act, which instituted significant reforms in corporate governance practices, particularly with regard to boards of directors.

These developments also served to draw scholars’ attention to the relationship between boards of directors and corporate governance. In light of the reform efforts being undertaken, scholars entered into a debate concerning the role and effects of the corporate board of directors that is far from over (Dalton & Dalton 2005). A rich literature has emerged which has undertaken to examine, among other issues, the proper structure of the board of directors (Baysinger and Butler 1985), the role of the board of directors (Hermalin and Weisbach 2000), the respective roles of both executive and non-executive directors (Bhagat and Black 2002), and perhaps the most important issue of all, the impact of the board on firm performance (Dalton, Daily, Johnson & Ellstrand 1999).

The beginning of research concerning boards of directors, however, does not date from the recent renewed focus on corporate governance issues. The genesis of board research coincided with theoretical developments in the area of strategic management that dealt with the firm’s leadership, and the emphasis on both the firm’s internal and external environments.

Early research in the field of strategic management was heavily influenced by the work of Bain (1956, 1968) and Mason (1939) with an emphasis on the “structure-conduct-performance” paradigm and on the firm’s external environment, and particularly on the structure of the industry. The firm’s competitive position within the industry was also emphasized. This perspective was reinforced two decades ago by the work of Michael Porter (1980, 1985) who put forth the view that firm performance was, in fact, determined by industry structure.

Despite the fact that early research in the area of strategic management underlined the importance of the firm's external environment, there were a number of scholars who drew attention to the inner workings of the firm, more specifically to the competences of the firm's top leadership. Selznick's (1957) study emphasized firm leadership and distinctive capabilities. Penrose (1959) related the success of the firm to its resources, with particular emphasis on managerial capacities. Other scholars (Cyert & March, 1963; Simon, 1945) emphasized the influence of behavioural factors of management on firms. Chandler (1962), in particular, drew a link between company growth and changes made in the administrative structure of firms to accommodate that growth. Further emphasis on the importance of the firm's internal structures, and the role of managers, can be seen in the work of Andrews (1971).

With regard to board research, these early theories had the effect of promoting a neat conceptual division between executive and non-executive directors. It was considered that successful boards are those that are able to strike an effective balance between issues relating to the firm's internal environment, and those relating to its external environment (Copeland & Towl 1947; Koontz 1967). The conventional view was that the orientation of the firm's executive directors is toward operations, whereas the orientation of the firm's non-executive directors is toward the external environment of the firm (Brown 1979; Quinn 1977). The emphasis on the monitoring and boundary spanning roles of NEDs would seem to coincide with this view.

There have been questions, nevertheless, as to whether this conceptualization of board member roles is reflected in reality (Bourgeois 1980; Korn/Ferry International 1982). The "inside-out" approach to management has stressed firm operations, while the "outside-in" approach has placed an emphasis on strategies that will enable the firm to respond to conditions in its environment. Research has traditionally divided the respective "roles" for such approaches between executive directors (the inside-out approach) and non-executive directors (the outside-in approach) (Andrews 1971; Pfeffer 1972). Some researchers have considered this a coarse conclusion (Pfeffer 1972; Schmidt 1975) which does not fully reflect the full range of contributions that NEDs can make to the firm. Research has indicated that director orientation and contribution to firm performance cannot be determined solely by whether the director is an executive or a non-executive (Vance 1983). One possible explanation for lack of conclusive data concerning the impact of directors on firm performance is that research has focused almost solely on "headcounts" of executive directors vs. non-executive directors, on board structure, rather than on more process-based criteria such as board roles and director competences.

Many scholars have stated that the emphasis on board structure has promoted a "one size fits all" approach to boardroom reform, and has obscured the fact that it would be difficult to identify what one might consider an "ideal" board structure. With firms varying from one another so much in terms of environmental context, some researchers have warned against assuming that firms have the same needs in terms of board structure and director attributes (Vance 1978).

These issues of board roles and director attributes have been eclipsed by much board research, which has often focused on the impact of board structure, i.e.-the ratio of executive vs. non-executive directors, on firm performance. In the last two decades numerous studies have tried to ascertain the impact of non-executive directors on firm performance (Molz 1988; Fosberg 1989; Schellenger et al. 1989; Hermalin and Weisbach 1991; Daily and Dalton 1992; Byrd and Hickman 1992; Gibbs 1993; Barnhart et al. 1994; Grace et al. 1995; Beasely 1996).

The empirical evidence concerning such an impact, however, is mixed. Some research has indicated that firm performance is improved as the number of NEDs present on the board increases (Barnhardt et al. 1994; Daily and Dalton 1992; Schellenger et al. 1989). Other research, however, has not found that increased numbers of non-executive directors improves firm performance (Hermalin and Weisbach 1991; Fosberg 1989; Molz 1988). Some studies even found a negative relationship between the number of NEDs on a board and firm performance (Bhagat and Black, 1999; Yermack, 1986). Results of meta-analyses have not provided a conclusive answer, either. A meta-analysis carried out in 1998 of 54 studies of the relationship between board composition and firm financial performance could not find any link (Dalton, Daily, Ellstrand, and Johnson, 1998). A meta-analysis carried out in 2000 of 59 studies of this relationship (Rhoades, Rechner, and Sundaramurthy, 2000) could find only a very small link between board composition and firm performance. Thus, after considerable research studying the effects of NEDs on firm performance, the results were summed up by James Westphal (2002) when he stated: "Nearly two decades of research find little evidence that board independence enhances board effectiveness".

Some scholars have responded to this state of affairs by suggesting that they have been looking for the source of NED impact on the firm in all the wrong places (Gillies and Leblanc 2003). They have suggested that the NED's contribution to the firm cannot be measured as a ratio of executive to non-executive directors. Scholars have called for a research emphasis that lends greater importance to board process rather than board structure (Corley 2005; Forbes and Milliken 1999; Hermalin and Weisbach 2000). Much of the board literature focuses on the question of what makes a board effective, and scholars are increasingly turning their attention to a number of board dimensions which have been underrepresented in the literature: the relationship between the role of the board in varying firm contexts, and the competencies & knowledge of directors themselves.

Board literature does contain examples of the examination of board roles (McNulty and Pettigrew 1999; Pfeffer and Salancik 1978; Westphal 1999). At the same time, scholars have yet to establish a clear set of roles to be undertaken by boards (Hung 1998; Johnson et al. 1996; Pettigrew 1992; Zahra and Pearce 1989). This lack of consensus has contributed to the focus in debates on corporate governance on the monitoring role of the board, and especially of NEDs. There have been, furthermore, increasing calls to more explicitly introduce a contingency perspective in the treatment of board roles: not all firms require the same board composition, and the fulfilment of the same board roles (Heracleous 2001).

The other neglected element of board research is director competencies (Hendry 2005; McNulty, Roberts & Stiles 2005). Human capital theory (Becker 1964) has assumed an increasingly important role in management research (Castanias and Helfat 2001; Nahapiet and Ghoshal 1998). Some researchers have called attention to the fact that the ability of directors to function effectively is dependent on their human capital: the ability of directors to develop strategy, monitor firm management, or provide advice & counsel will, to some extent, be a function of the competencies, experience, and knowledge of the directors. In a word, the ability of the board to function as a board will depend on its human capital (Kiel and Nicholson 2002).

Very little empirical research has been undertaken which examines the impact of the human capital of the board on firm performance. Certain theoretical streams have approached the issue: the Resource Based View (Barney 1991) introduced the idea of a firm's managers as unique resources leading to firm competitive advantage. Hambrick and Mason (1984) introduced the Upper Echelons Perspective, which posits that firm strategy and performance will reflect the background and experiences of the firm's top management team (TMT). These perspectives, however, have mostly been applied to empirical studies of CEO's

(Finkelstein and Hambrick 1996) or top management teams (Harvey et al. 1994). While boards of directors and TMT's share some of the same organizational functions and responsibilities, the board is distinctive enough to warrant study in these theoretical streams in its own right (Forbes and Milliken 1999).

The recent calls for an emphasis on director competences in research, and for competent directors on boards, should be accompanied by empirical research which measures the impact of board human capital on firm performance (McNulty, Roberts & Stiles 2003; Pye & Pettigrew 2005). Much board literature today emphasizes the need for "competent directors", yet we know very little regarding what competences, in what circumstances, make for an effective director (Gillies and Leblanc 2003, Nadler 2004). In addition, such research should avoid the "one size fits all" approach and integrate this impact through the mediating effect of board roles, and the moderating effect of firm environmental context.

III. Director Competencies and the Execution of Board Roles

As mentioned above, much board research has been to a certain extent stymied by the fact that academics have been unable to establish an unambiguous relationship between director "independence" and firm performance. It is for this reason that a new conceptual framework is needed, one which emphasizes board processes. In this section I shall lay the groundwork for this conceptual framework, and make propositions concerning future directions of board research.

Taken together, knowledge, skills, and experience go to make up what is called "human capital", and when brought together on a corporate board, represent a formidable resource for the firm. The human capital of directors remains an understudied area in management research. Furthermore, the human capital of NEDs in particular has been almost entirely neglected. Nevertheless, human capital is the basis for intellectual capital, and thus has a preponderant influence on the capacity of directors to act in support of the firm.

One of the problems inherent in trying to establish a link between the board of directors and firm performance is that boards themselves face a very wide range of tasks and responsibilities. It is necessary for future research to disentangle the numerous strands of director identification and director impact by focusing specifically on the competencies of directors as well as on the role that is played by directors, especially non-executive directors.

An important question which needs to be addressed by the research is whether board composition is undertaken with NED human capital (competencies) in mind, and, do the competencies of NEDs lead to NEDs undertaking different activities on the board, and fulfilling different roles? This issue is important insofar as a NED's value as a monitor, for example, is going to depend, to a large extent, on the NED's ability to fully comprehend, and address, the business situation that his or her firm is facing. In view of the fact that NED competencies may represent a significant asset for the board, it is somewhat surprising that almost no research has been undertaken to address this potentially significant contribution of the board. Much research has been undertaken which applies human capital theory to CEO's (Castanias and Helfat 2001) and to top management teams (Harvey et. al. 1994), but I believe that the distinctiveness of the NED is enough to warrant that such research be undertaken solely with regard to NED competencies, and this because of the difference in the roles played by the NED vis-à-vis the CEO and the top management team in general.

It is important, therefore, to build upon the current process-oriented research agenda by developing a model which links the competencies of NEDs to firm performance by means of the roles that NEDs perform. In order to accomplish this, the competences of NEDs need to be identified and classified, and these competences need to be analyzed in terms of the roles that NEDs fulfil. I propose that research into the impact of NEDs on firm performance should focus not on one role considered in isolation (monitoring, for example), but on a set of roles.

The issue of examining NED impact on firms in light of the roles fulfilled by NEDs is critical, in that the competences required to be an able monitor of a complex, and perhaps large, organization are not the same competences required to assist in the development of firm strategy. Furthermore, any analysis of the impact of NEDs on the firm needs to recognize that NEDs can contribute to the firm in several ways: by providing access to resources (Pfeffer 1972), by providing advice and counsel (Kesner & Johnson 1990), and by developing corporate strategy (McNulty & Pettigrew 1999), among other roles. In summary, an understanding of NED contributions cannot be understood outside the context of the roles played by NEDs.

What are the principal roles played by the NED? The role set executed by NEDs has evolved over time, and has been conceptualized by different researchers in different ways (Hung 1998; Johnson et al. 1996; Lipton & Lorsch 1992). In the past, NEDs were largely considered to play "ceremonial" roles, and were once famously compared to "ornaments on the corporate Christmas tree" (Mace 1971, p.90). Most researchers have operationalized the role of the NED according to the following framework:

- Support for management

- Formulation of strategy

- Monitoring of management behaviour

- Serving as the nexus among competing groups, such as shareholders, and other stakeholders.

- Serving as boundary spanners, linking the firm to the external environment.

Despite the wide variety of roles that researchers have recognized for the NED, the corporate scandals of recent years have served to place perhaps undue emphasis on the role of the NED as monitor. This emphasis is seen not only in the business press, but also in international guidelines relating to corporate governance reforms (Higgs 2003; NACD 2000; OECD 1999).

I therefore posit the following propositions related to NEDs and the roles that they fulfil:

P1: The effectiveness of a NED will depend upon the successful execution of a set of board roles, and is not solely a function of the NED's effectiveness as a monitor.

P2: The effectiveness of a NED will depend upon the level of human capital which he or she brings to the board, expressed in terms of competences.

P3: The competences of NEDs will more accurately explain the impact of NEDs on firm performance than will measurements of NED independence, and the ratios of executive to non-executive directors will.

IV. Director Competences and the Orientation of the Non-Executive Director

Rapid advances in technology and increased globalization of firms have brought an increased focus to the manner by which firms enhance their levels of competitive advantage. The traditional strategic distinction between "fit" and "stretch" has been further accentuated by the importance attached to the resource based view as a means of explaining the most effective means by which a firm is able to compete. The debate concerning whether a firm's competitive advantage rests in its successful engagement with its external environment or with the unique resources and capabilities nested within the firm may be extended to the role of the NED.

The traditional view of the role of directors postulated that executive directors would concern themselves with firm operations, while the firm's relationship with its external environment would be managed, to a certain extent, by the non-executive members of the board. In light of the competence based view of the role of NEDs which is presented here, the traditional construction of board roles is called into question. While in its broadest presentation, no one would deny the validity of such a breakdown of director roles, I present a framework here which is more nuanced, and does not break down the role of NEDs according to such clearly delineated parameters.

Strategic management research has shown that the "traditional" breakdown of the strategic orientations of the firm's upper echelons have been useful, but that empirical studies which view executive directors as being "firm-oriented", and non-executive directors as being "environment oriented" have not led to conclusive results that would adequately explain the role and the impact of the non-executive director. The lack of conclusive results may be because the analysis of the orientations of the members of the firms' upper echelons was based solely on the individual's position in the firm: executives were tested assuming their orientation was "internal", and outside directors tested assuming their orientation was "external".

The introduction of the analysis of the impact of NEDs on firms according to director competences permits us to achieve a much clearer picture of how, and in what circumstances, the NED affects the firm. In the framework that is proposed here, directors' "strategic orientation" will be classified according to their competences. It is proposed here that a NED does not have, by definition, an "external orientation". In other words, it is not the label that determines the strategic orientation of the NED, it is the competences that the NED brings to the firm.

In summary, this article proposes that measures of competence will provide a more meaningful basis for correlating the internal or external orientation of a firm's directors with firm performance than will labels such as "executive" or "non-executive".

This leads to the following proposition:

P4: Measures of the internal or external strategic orientation of directors based on competences will be more closely correlated with measures of firm performance than will measures based on coarser classifications such as "outsider" or "insider".

V. The Impact of Contingencies on the Role of the NED

The framework presented here underlines the importance of integrating a contingency perspective. If the activities of NEDs are going to encompass a broad set of roles, it is to be expected that the roles fulfilled by the NED will be contingent upon the circumstances encountered by the firm itself. Different circumstances will lead to different emphases among the board roles executed by NEDs. Any research which takes a competence based perspective will need to take this into account. The competences possessed by one NED might be highly valuable to one firm, but might be less valuable to another firm, based on each particular firm's unique circumstances.

For some time, studies in the area of strategic management have underlined the fact that the resources and structures of firms must fit their external environments. Previous studies have emphasized the role of non-executive directors in linking their firms to financial institutions, particularly in the context of an IPO (Higgins & Gulati 2000). Overall, the industry life cycle has proved to be a useful contingency measure when determining the impact of the board on firm performance. It is proposed here that the industry life cycle will be a primary contingency variable influencing the kind of competencies that will be most valuable at any given time in the life of a firm. Other contingencies that would play a significant role would include: organizational size, diversity, management experience, and industry turbulence.

The importance of contingencies to the competence based perspective for directors leads to the following proposition:

P5: Both external and internal contingencies will moderate the relationship between director competences and the execution of board roles.

VI. Conclusion

"The key to better governance lies…in the competence…of individual directors."

(Nadler 2004)

The board of directors is the firm's most important decision making group. Understanding how the board affects firm performance has been, and remains, one of the critical tasks facing management researchers. This paper proposes a board research perspective that integrates director competences, board roles, and environmental contingencies into the overall framework of board research.

Basing future research on the competences of NEDs might serve to challenge the conventional wisdom that states that the non-executive director's contribution to the firm stems from his or her links to the external environment. While NEDs may be, in a formal sense "outsiders", their strategic orientation, and their contribution to firm competitive advantage, may be based more on the contributions they can make to the internal functioning of the firm. This has practical implications for the firm: NEDs who are expected to function as boundary spanners may fail to fulfil this role if their competences are oriented more toward the internal workings of the firm.

The purpose of this paper has been to provide the foundations for a framework that will enable researchers to test the extent to which the above statement from board researcher David Nadler is true. One of the first steps in finding an answer to the question of whether the competences of individual directors lead to better governance is to establish a framework for evaluating the impact of the competences of NEDs on firm performance. I choose to emphasize NEDs because much board research has focused on NEDs, but almost exclusively from the standpoint of board structure and not from the standpoint of the impact of their competences. Using the theoretical lenses of human capital, the resource based view, and the upper echelons perspective, this framework attempts to define the types of NED competences that have the greatest impact on firm performance. It also proposes to examine this impact, not through the more narrow focus of one board role, but rather through a set of roles that will enhance knowledge concerning when, and in what circumstances, NEDs add the greatest value to the firms they serve.

Previous empirical work regarding the board of directors has focused on the structure of the board, dealing mainly with questions of board composition and director independence, to ascertain board influence on firm performance. The results have been largely inconclusive.

This inconclusiveness has led some scholars to say that board research has been undertaken too narrowly for too long, and that future research must focus more on the issue of board process. Some scholars have said that director competences contribute more to board effectiveness than the simple measure of "director independence" does, and have called for more research to focus on director competences. This paper contributes to the wider discussion of the impact of director competences on the execution of board roles and their impact on firm performance.

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