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Abstract

Directors play an important role in influencing board's action and its effectiveness (Adams, Hermalin, & Weisbach, 2010). Therefore, corporate governance researchers have looked extensively at the determinants of director selection in a firm. Most of the work in this literature has looked at board composition and its size. However, there is limited amount of work that looks at the determinants of the role directors play in firms. Directors are expected to have both social and human capital and that is why they are invited on the boards of the firms. However, which of these capitals are they supposed to exploit more is not studied much. This is where this paper makes an attempt to contribute to the existing literature. In this paper, we present propositions on factors that determine the roles directors play in firms. We focus on three major roles that are played by directors: advisor, resource provider, and monitor. We argue that factors like firm's characteristics (size, age, ownership structure), environmental dynamism, and life cycle stage of the firm determine which of these three roles will be played by the directors of the firms.

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INTRODUCTION:

Board members or directors have multiple identities and play multiple roles in a firm. According to agency theory, board members have fiduciary responsibility towards shareholders and their main role is to monitor the management and its actions to ensure fair distribution of wealth among shareholders (Jensen and Mackling, 1976). Agency theory assumes opportunistic nature of human beings and therefore it expects managers (CEO) to draw private benefits from the firm and expropriate shareholders wealth. Directors who represent shareholders are expected to oversee management to ensure such expropriation is minimized and firm's management works towards longevity of the firm. In this role, directors are active questioners of firm's management and its status quo.

Similarly, Resource dependence view expects directors to play role of advisor and resource provider (Hillman and Delziel, 2003). Pfeffer and Salancik suggested three main benefits that firms can have from board members: (1) advice and counsel, (2) organization legitimacy, and (3) preferential access to resources from external environment (1978: 145, 161).

Both agency theory and resource dependence view present rational economic perspective on directors' role in the firm. According to these views, directors are required to fulfil monitoring and/or resource needs of the firm. Monitoring and Advisory roles will be related to human capital of the director where human capital can be defined as specific skills, knowledge and expertise of the directors (Withers, Hillman, and Cannella, 2012). Resource provider role will be related to social or relational capital of the firm where social capital refers to reputation and network of the director (Withers, Hillman, and Cannella, 2012).

Researchers have looked at the determinants of directors selections (mainly board composition in terms of outside and inside directors and board size) using these two perspectives or views. We argue that directors generally have both social and human capital (Hillman and Delziel, 2003); but which of the capital will be valued more depends upon both firm and industry related factors.

Though we must admit that it is very difficult to distinguish between social and human capital of a director (Haynes & Hillman, 2010) mainly because it is very difficult to observe board and its behavior.

This paper contributes to the existing literature in three ways: First, it makes an attempt to look at individualistic characteristics of directors and how directors' role may get determined by firm and industry specific factors. Most of the work in the existing literature examines broad characteristics of the board; in this paper, we try to bring out nuances related to the role of board members. Second, the paper looks at some of the independent variables that have not been examined in the literature earlier like firms' size, age, ownership structure. Third, this paper can have important implications for policy makers as well; since the role of board members is context dependent, policy makers can think of having separate governance norms depending upon the contexts in which firms operate.

LITERATURE AND PROPOSITIONS:

As mentioned earlier, there is immense literature on board's selection; in fact most of the work cuts across various disciplines like strategy, finance, organization behavior, economics, and public policy. In each discipline, researchers have mainly focused on board's composition. Researchers have examined the impact of firm's strategy, external environment, firm's life cycle on board's composition and size. This is the demand side of view of the board where board is expected to meet demands of the firm. Similarly, researchers have also looked at the supply side view of the board in which how directors decide which firm to get associated with has been studied. Further, economic perspective of board composition has also been complemented with social perspective of board composition. Social perspective looks at embeddedness, biases that play important role in board composition.

In this paper, we are going to focus on economic perspective only where board is expected to meet certain demands of the firm. We present various propositions below.

Firm's life cycle of growth determines the role directors would play in the firm:

Existing literature on corporate governance does look at the impact of firm's growth life cycle on board's composition. However, impact of the life cycle on individualistic role of board members have not been studied.

There are different stages of growth in a firm's life cycle starting from Survival, Success, Growth, Resource Maturity, and Decline (Quinn and Cameron, 1983). Each stage poses a different demand in terms of resources, capabilities, management, coordination, and control on the organization (Lynall, Golden, and Hillman, 2003). For example, when the firm is at survival phase, owners get involved in all-operational, administrative as well as strategic activities/decisions. In such a phase, main requirement of the organization would be to have an advisor who could guide the management in the right direction.

Similarly, in success stage, the firm needs financial resources to grow further. Chen, Hambrick, and Pollock (2008) support this view; they have looked at board composition in the initial stage of growth cycle that is when the firms is about to go for initial public offering (IPO). According to these researchers, firms draw prestigious directors just before the IPO to get higher valuation. After success, firms need to grow bigger and this is where professionalization of firm and its systems and processes will be required. In such a phase, directors who have experience with professionalization of other firms would be helpful. In resource maturity phase, directors would play role more of a monitor.

Since the requirements of the firm changes with each stage, the roles directors can play in such a firm with each passing stage of growth cycle could be different too. Depending upon the expertise of the board members, their relevance in a particular phase/stage of firm's growth may increase or decrease. Therefore, firms shuffle their boards as they move from one phase of growth to the other.

Proposition 1: Firms shuffle their board as they move from one life cycle stage of growth to the other.

Proposition 2 : As the firm moves from survival to success, to grow and finally mature stage, role of board changes from advisor to resource provider to monitor.

Dynamism of External Environment determines the role directors play in the firm:

Strategy Literature has given a lot of importance to the role of external environment in each stage of firm's life cycle of growth. Managers are expected to formulate strategy that is in alignment with external environment. Since changes in environment poses different demands on the firm, therefore it also influences the role directors play in this firm. Extant literature (see work of Davis & Cobb, 2010; Hillman, Withers, & Collins, 2009) has examined the impact of external environment on board's composition and board's size. Researchers like Boyd (1990) has empirically shown that uncertain environment leads to smaller board size. Similarly, Markarian and Parbonetti (2007) have empirically shown that externally complex environment of a firm leads to more number of outside directors on the board and internally complex environment leads to more number of inside directors on the board.

However, there is hardly any work that looks at role of uncertain environment in determining the role directors would play. For example, when the environment is changing very fast (dynamic), then the managers are expected to make quick decisions. In such an environment there is less time for analysis and managers have to rely on their intuition and past experiences. Therefore, directors experience of the industry and dealing with uncertain and dynamic situations play crucial role in guiding the management. Therefore, directors' advisory role becomes more important in such an environment.

On the other hand, when the environment is stable, level of uncertainty is fairly low. In such an environment, managers can focus on growth and look out for more opportunities in the external environment. Therefore, director's role in such cases would become more of a monitor and/or resource provider. On the basis of these arguments, we propose that

Proposition 3: In case of dynamic environment, the manager needs to make decisions fast; under such circumstances, advisory role of an experienced director could enhance firm's performance

Proposition 4: In case of stable environment, directors are expected to play the role of a monitor and/or resource provider.

Role of firm's characteristics in determining the role of directors:

Researchers have explored impact of firm's performance on board composition. For example, Daily and Dalton (1995) have shown that directors' turnover is high following firm's bankruptcy and thus impacting board's composition. Similarly, Finkelstein, Hillman, and Cannella (2009) have shown that directors value their reputation in the corporate world and therefore, independent directors exit poor performing firms.

However, there is no work that looks at the impact of firm's characteristics like size, age, and ownership structure on the roles directors play in the firm.

Firm's size is a proxy for firm's resources. Large firms have more resources as compared to small firms. Therefore, firm is not dependent upon the director for his/her access to resources. Large firms also indicate that information processing across departments/divisions/businesses will be a complex task in such firms. Consequently, the chances of information asymmetry and hence goal misalignment among managers and shareholders could be more and therefore, board or directors are expected to play the role of monitors and oversee management's actions.

Proposition 5: Large firms have more resources and hence may not be dependent upon directors for resources, therefore, role of directors in such firms will be more of an advisor and/or a monitor.

Similarly, age of the firm is also associated with resources to some extent. More than that, age of the firm indicates bureaucracy in the system and such firms are generally less flexible when it comes to adaptability to the changes in the environment. Further, old firms have institutionalized

certain routines, practices, and processes. These firms have a tendency to resist any organizational change that the environment poses on them. Therefore, role of director in such firms is more of a monitor to ensure that management responds to environmental demands.

Proposition 6: Role of board members in old firms will be more of a monitor.

Ownership structure or shareholding pattern of the firm also impacts the role directors can play. When there is a majority shareholder in the firm who has controlling rights on the decision making, then such a shareholder does not want the director to monitor management or interfere in the decision making. To give an example, family firms where family has the majority shareholding in the firm do not like to have outside directors because the owners want to have full control over the decision making and they see outside directors' interference in the firm as dilution of their control. Even when such firms have to abide by the corporate governance norms of the country and have outside directors on the board, they expect these directors not to play the role of a monitor. Therefore, role of board in such firms will be more of an advisor and/or a resource provider.

Proposition 7: Majority owned firms have block holders who have controlling rights on decision making; such firms expect boards to play role of an advisor or resource provider rather than of a monitor.

Similarly, firms with active shareholders like foreign corporate and foreign institutional investors would expect directors to play role of a monitor as per the norms in western world. These owners are active in raising their voices against the management and majority owner if they feel their wealth is being expropriated.

Proposition 8: Directors play role of a monitor in firms with active shareholders like foreign corporate and foreign institutional investors.

DATA:

To test above mentioned propositions, we are conducting interviews with owners of small and medium enterprises (SMEs) in India and we plan to do the same for large enterprises as well. So far, we have conducted twelve interviews of the owners of SMEs that are not listed on any of the stock exchanges. Some of the observations that have come out of these interviews are as follows: Owners of SMEs perceive outside directors as a threat and that is why they do not even go for external funding to grow their firms. SMEs with no outside director state director's interference in decision making as the main reason for not having one on the board. SMEs with outside director on the board have benefitted from directors expertise and knowledge. These SMEs are larger in size as compared to SMEs with no outside director on the board. However, in both the categories, we have firms in survival as well as success phase of growth cycle. Some of these firms have been there for more than 25 years and they do not aim to grow further and therefore, these firms do not feel the need of having outside directors on board; owners of these firms are happy with status quo.

All these firms are 100% owned by families and hence the owners want outside directors to play the role of an advisor rather than of a monitor. Surprisingly, none of the owners of the firms with outside directors viewed directors as a resource provider. One possible reason for this could be that the outside directors are not very well known people in the corporate world and therefore their social capital is low.

Further, SMEs, we have been able to interview so far, belong to industries with stable environment. More interviews will help us in bringing out the impact of environment on role of directors in such firms.

CONCLUSION:

This paper assumes that firms constitute board of directors to meet monitoring and resource related demands of the firm. Most of the corporate governance norms in any country expect board members to play role of a monitor. Though the corporate governance literature acknowledges other roles (like advisor, resource provider etc.) being played by the board members; yet policy makers and government imposes minimum number of outside and independent directors on the firms to mitigate agency cost and monitor management. Main purpose of the government is to protect shareholders' right. This paper makes a case for giving importance to other roles of directors as well while making policies and regulations. Regulations may impose outside directors on a firm, however the outside directors might be required to play role of an advisor and/or resource provider rather than the expected role of a monitor. While playing such roles as well, directors are helping management to increase shareholders' wealth. Therefore, board's effectiveness is not necessarily based on its monitoring role or how independent are the independent directors. Board's effectiveness could be related to advisory and resource provider role as well depending upon the demands of the firm.

Therefore, policy makers and researchers need to consider other roles of board as well while drafting policies. Managers of the firms need to understand their firm's internal and external context to have the right kind of board in their firm so that firm's performance can be improved upon.

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