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Board Involvement in the Strategic Decision Making Process: A Comprehensive Review

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Board Involvement in the Strategic Decision Making Process: A Comprehensive Review

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ABSTRACT

The board of directors is legally responsible for setting the strategic direction of the firm and for ensuring the firm's long-term performance in almost all governance environments. However, many boards delegate part or all of the task of creating and executing the firm's strategy to a group of full-time professional managers. This separation between ownership and control creates many challenges for the modern-day firm, and the board's role in the strategy formation process is arguably the seminal governance challenge confronting boards today. This study examines this seminal challenge by: (1) Introducing background information on this stream by defining key terms and discussing its importance to the wider corporate governance literature, describing three infamous case studies of firms based in the USA, Europe and Asia where the board was insufficiently involved, and noting situations where the board may become too involved; (2) Exploring previous reviews of this research stream on board strategic involvement, and discussing the

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evolution of this construct and related studies over time; (3) Analyzing previous research designs used in this research stream while identifying the frequency as well as costs and benefits associated with each; (4) Summarizing what we currently know about the multi-level antecedents of board involvement within single countries; (5) Specifying some of the national-level antecedents of board involvement identified in cross-national studies; (6) Identifying the subsequent multi-level effects of board involvement; and (7) Discussing the implications of this review and outlining future research directions.

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1

Introduction to the Board Involvement Stream

1.1 The Nature and Importance of the Board Involvement Stream

In almost every organization that is a legal entity, a group of individuals is sanctioned to make sure that the organization has a carefully-crafted strategy which helps to assure its overall organizational effectiveness. This group of individuals is put in place to represent the various stakeholders engaged with the organization. In "micro" organizations, the oversight group of individuals often consists of insiders to the organizations. In organizations larger than "micro" status, this oversight group typically consists of insiders and part-time outsiders. In practice, this group of individuals, which typically operates under the name of 'board of directors' or 'trustees', delegates to senior leaders the task of developing a sound strategy and once approved, the responsibility to properly execute that strategy (Berle and Means, 1932).

While the number of roles that the board fulfills varies, there are essentially two broad roles for every board. The first, and most discussed role, is its monitoring role. In this role, the board is responsible for keeping informed and engaged with the firm to assure that the interests of the firm's stakeholders, and particularly its owners, are protected. With respect to the board involvement stream, the monitoring role

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also involves the board overseeing the execution of previously chosen strategies and tactics. This can occur in both ex post and ex ante situations (Jensen and Meckling, 1976; Dalton *et al.*, 2007). Accordingly, the board can oversee whether goals and plans of the firm have been realized (ex post monitoring) and/or observe the top management team's decision-making with the intention to surveil whether these decisions can be expected to be successful to meet the firm's goals and aspirations (ex ante monitoring).

The second, and much less investigated role, is the board's service role (cf. Hillman and Dalziel, 2003; Johnson *et al.*, 1996; Zahra and Pearce, 1989). In this role, the board may take on direct responsibility for making major strategic decisions, such as in times of crisis or when confronted with CEO succession decisions (Mace, 1971); or it may take on a more indirect role for advising and counseling the top management team in its strategic deliberations (Adams and Ferreira, 2007). Whereas monitoring refers to notions of control and tends to constrain the firm's management, the service role is about support and aims at strengthening strategic decision-making – a delicate balance with which every board must wrestle.

Effective strategy formation requires in-depth knowledge of the organization and its environment (Charan *et al.*, 2014; Lorsch and MacIver, 1989). This reality is a central source of the problem – how can directors or trustees who only operate as part-time overseers and advisors, effectively contribute to, appraise, and challenge the development and execution of the firm's strategic orientation? In other words, what is the proper type of involvement by the board to assure the firm's future success and longevity? This research stream, known as the "board involvement" stream, is the focus of the present review.

This particular stream of research has preoccupied scholars from strategy, economics, sociology, finance, accounting, law, and ethics for several decades now. Furthermore, the nature and expectations associated with board involvement vary considerably from country to country, so comparative governance scholars from the various disciplines above all seek to learn how this essential governance practice differs across national boundaries. The time is ripe for a comprehensive review of this societally-important research stream.

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1.2 Case Studies Illustrating the Problems Associated with Lack of Board Involvement

As usual, scholarly interest follows practitioner and policy maker interests. Indeed, every time the 'black box' of board functioning (Lawrence, 1997) is opened up and found to be negligent, both policy makers, media officials, and business practitioners become concerned. Following corporate scandals around the world, governments and the society at large became aware that boards may have neglected their roles by rubber stamping managerial reports and failed to get sufficiently involved in decision-making on the overall strategy or important strategic initiatives.

Enron, for instance, was once identified as one of the "best governed corporations in the United States" (Fox, 2003). Similarly, *Fortune* magazine identified it as one of the most-admired, best managed corporations in the world. At the time, Enron was the seventh-largest corporation in the United States employing 25,000 people all over the world, engaged primarily in energy trading deals. However, on August 14, the CEO, Jeff Skilling resigned and shortly thereafter the biggest bankruptcy thitherto in US history unfolded. The fifteen members of Enron's board were heavily criticized for the oversight failure, and the famous (and infamous) Sarbanes-Oxley legislation was put into place in the aftermath of the Enron collapse (Hamilton, 2003). While the initial press reports focused on the lack of board monitoring of day to day functioning, subsequent post mortems have concluded that the board's lack of involvement and understanding of Enron's strategy was the more serious failure of the board (Deakin and Konzelmann, 2004; Higgs, 2003; Sonnenfeld, 2002).

However, it was not just American firms that experienced inadequate board involvement. Parmalat is one of the largest food processing companies in the world and it was based in Collecchio, Italy. In the presence of a dominant top management team beholden to the founding Tanzi family, external auditors and bankers all failed to understand the rampant fraud going on within the firm. In general accounting irregularities were reported to the public on December 19, 2003 (Tapies, 2005). Tanzi resigned as CEO and board chair shortly afterwards. Literally

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billions of euros went missing and the board was highly criticized for its lax attention to proper accounting standards and inadequate strategic involvement (Hamilton, 2004).

Satyam Corporation provides an example of the disastrous consequences of inadequate board involvement in Asia. Satyam was an Indian computer service company and the fourth largest IT firm in India. The company offered IT outsourcing services to around 690 clients, including a large number of prominent Fortune 500 firms, and was operating globally in 37 countries (Baxi and Yadav, 2010). In 2009, the then Satyam chairman confessed that the firm's financial statements had been falsified as corporate cash and bank balances, revenues, operating margins as well as the number of employees were significantly inflated. This scandal let to a severe decline of the firm's stock prize. At the New York Stock Exchange, Satyam share prices dropped to less than 2 USD in March 2009, after they peaked in 2008 at 29.10 USD. Finally, Satyam was taken over by Tech Mahindra (for more details, see Singh *et al.*, 2010). Apparently, it was not only the auditor – the Indian arm of PricewaterhouseCoopers that was fined by the SEC for violating its code of conduct and auditing standards – but also the board of directors who neglected its duties of effective monitoring and oversight. B Ramalinga Raju, the company's founder and former chairman, has been found guilty and sentenced to seven years in jail. The overall fraud amounted to about 1.4 billion USD (Baxi and Yadav, 2010). Satyam has therefore also been termed "India's Enron" (Afsharipour, 2009, p. 341). Notably, Satyam gained sad prominence of being India's biggest incidence of corporate fraud. Once again, a more involved and engaged board of directors whose members are familiar with and engaged in strategic decision-making process may have helped to avoid this disaster and its preceding malfeasance.

In all three cases, the non-executive directors merely rubber stamped the top executive proposals and there was no effort to ask penetrating questions or seek alternative views. While the focus of the news press was on the board's monitoring role failure, a separate and equal advising and counseling role on strategy was also neglected. A delicate balance exists between the board of directors and the top management team – the board has to trust the top managers, but they should also make

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sure that this trust is well placed and need to understand the logic and direction behind the organization's strategy. The board has to create a culture of openness and dissent and to ensure that challenging views and opinions does not compromise perceived loyalty (cf. Nadler, 2004; Sonnenfeld, 2002). Unfortunately, the business press is littered with examples where this delicate balance was ignored and the board failed to get properly involved.

1.3 Board Involvement Can Become Excessive and Counter-productive

Boards vary in how much authority they delegate to executives (Useem and Zellek, 2006). Whereas boards are accountable for the strategic direction of the company, they delegate large sections of this task to corporate management because directors operate part-time, have additional responsibilities outside of the firm and may have limited familiarity with the firm's business operations and its environment. The general focus in this stream of studies is therefore on under-involvement, as also suggested in the three case examples outlined above.

However, some boards may also get too much involved with strategy development and heavily constrain and/or discount executives' strategic discretion. Indeed, some boards arrogantly impose their will on top management, choosing to not trust the executive team at all thereby undermining the top management team's authority (Adams and Ferreira, 2007). Notably, Charan *et al.* (2014) estimate that amongst roughly half of all Fortune 500 firms, there is at least one director serving on the board who tries to micromanage the senior executives and routinely damages proper strategy formation.

One explanation for this over-involvement is due to boards being pressured to do more in an increasingly complicated competitive environment. Another explanation is that engaging in strategic decision making is more rewarding and interesting than watching management and waiting for them to make a mistake. As a result, it is no surprise that corporate surveys reveal that the board of directors is spending more and more time on understanding, questioning, and refining the firm's strategy (McKinsey, 2016).

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Today, it is widely accepted that one of the central responsibilities of any board is to set strategic direction for the firm and ensure its long-term survival. The board needs to assess the appropriate level of delegation to the firm's top management that allows the board to be sufficiently involved and to enable management to bring its specific expertise into the formulation and implementation of corporate strategies. The question always has been and will continue to be: How do part-time directors serving on the board get involved effectively in the strategic decision making process of the firm?

1.4 Ex Ante and Ex Post Board Involvement

Although most of the corporate governance literature has focused on the (ex post) monitoring and control role of the board (*e.g.*, Boivie *et al.*, 2016; Daily *et al.*, 2003; Shleifer and Vishny, 1997), this stream of research complements that traditional line of inquiry by examining the other equally, if not more important, role of the board in its advising, counseling and service role. Indeed, Judge and Zeithaml (1992) were some of the first scholars to emphasize that board involvement in strategic decision making dealt with the (ex ante) strategy formation process, and this was followed by the (ex post) strategy evaluation process. In the latter situation, the board's monitoring role gets expanded by not just staying on top of the firm's overall performance, but it also considers the reasons behind that performance (*i.e.*, its strategy) and the skill by which that performance is generated (*i.e.*, the execution of the strategy).

The tension in this stream emanates from the different knowledge bases and role orientations of executive versus non-executive directors serving on the board. Non-executive directors are expected to be objective overseers of the executive team. However, that "objectivity" comes at a high price with respect to board involvement because it brings with goals that can sometimes be at odds with the executive team, yet the executive team will always have a knowledge advantage over the non-executive directors.

There are some who argue that part-time non-executive directors are no longer feasible, particularly for large corporations, and that there

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needs to be a movement to full-time professional directors (Fram, 2005). Indeed, there is some empirical evidence suggesting that full-time professional directors are more effective than part-time non-executive directors are (Keys and Li, 2005). While we are sympathetic to that public policy position, it highlights the practical and theoretical challenges associated with this research stream.

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