

Are boards on board? A theory of corporate board influence on sustainability

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ABSTRACT: A model is developed that takes into account: (1) human capital of outside directors; (2) social capital of outside directors; and (3) human and social capital of CEOs. Beyond this, values are largely neglected in the examination of boards of directors, and are also necessary in the study of sustainability given its normative implications. The model thus accounts for the *value attunement* concept as a moderating variable. The model proposed in this paper offers original insight into the drivers of sustainability performance in organisations and hence, advances corporate governance theory.

Keywords: boards of directors, corporate governance, human capital, social capital, values, sustainability

As the highest level decision-makers (Fama & Jensen 1983), do boards of directors have an influence on firms' sustainability performance? Given that the evidence is thus far inconclusive, additional research is needed as sustainability is gaining corporate attention and requires a response (Haanaes et al. 2011). For example, Lubin and Esty (2010) suggest that sustainability is fast becoming a business 'megatrend', an imperative that firms must address in an increasingly open, transparent, and socially aware world. Similarly, Bansal (2002) argues that there is now general acceptance that for a planet that is sustainable in the future, corporations must engage in sustainability as a matter of strategy and policy because they represent the productive resources of the economy. The evidence does suggest that firms are increasingly paying attention to sustainability (Haanaes et al. 2011). This paper therefore seeks to develop a model of how boards shape whether a firm accepts or disavows sustainability, particularly by examining the role of boards and the extent that individual directors enact their values.

According to the literature, boards have two principle roles. First, drawing on agency theory (Fama & Jensen 1983; Jensen & Meckling 1976), boards act as agents of owners to monitor management. The monitoring function oversees the alignment of shareholder and management interests, ensuring that these do not diverge substantially (Dalton Hitt, Certo & Dalton 2007). Because of the emphasis on monitoring and control, agency theory prescribes that boards should consist mainly of independent, outside directors (Fama & Jensen 1983). Second, other theories suggest that the main role of the board is one of resource provision (Pfeffer & Salancik 1978). Given their ties to external constituents, outside directors provide key resources, such as information, strategic advice, counsel, and other important resources that can impact on firm strategies and legitimacy (Kor & Sundaramurthy 2009). Integrating

agency and resource dependency theories, the board capital perspective (Hillman & Dalziel 2003) demonstrates that boards' human and social capital influence both monitoring and resource provision roles. However, the model presented in this paper demonstrates that while outside director capital is necessary, other conditions are required to ensure that sustainability performance is adequately monitored and that sustainability concerns are integrated into decision making at the board level (Figure 1). Two other factors have impact.

The second factor relates to CEOs. CEOs have significant influence on board decisions; however, their powerful influence can subvert decisions necessary to move firms forward beyond the *status quo*. For CEOs to be willing to accept monitoring on sustainability performance and advice and counsel on new strategies such as those embracing sustainability, CEO-specific forms of human and social capital are necessary. Lastly, sustainability is inherently normative. That is, addressing sustainability is normative because it requires firms to confront what they should or should not do on behalf of the social good. Hence, an examination of *values* should be considered in any discussion of boards of directors and decision-making on matters related to sustainability.

SUSTAINABILITY CONCEPTS

Dominant theories of the firm conceptualize firms as profit-seeking entities, with the sole purpose of maximizing shareholder wealth (Kantarelis 2010). These are exemplified by Henderson (2005), who argues firms are the basic unit of value creation in society, charged only with producing economic growth and wealth. Amongst scholars, little disagreement is likely to arise about this basic function of firms; on the other hand, there is serious debate about an extended set of goals beyond profit maximization. A full review of these debates is beyond the scope of this paper. However, sustainability is an emerging paradigm facing the business community, if not an 'imperative' (Lubin & Esty 2010, p. 50), and response to this issue is a matter for the highest level of decision-makers to consider, namely, the board of directors (Elkington 2006).

As a concept, sustainability continues to evolve; however, sustainability is generally understood as 'meeting the needs of the present without compromising the ability of future generations to meet their

own needs' (WCED 1987, p. 43). From this definitional base, there seems to be some implicit consensus among scholars that sustainability consists of three principles—economic viability, environmental quality, and social responsiveness (Rake & Grayson 2009). These three principles are interrelated and interdependent. That is, at the core of sustainability, firms should demonstrate economic, environmental, and social performance alike in order to achieve long-term prosperity of the firm and to contribute to the long-term prosperity of society and humankind (Bansal 2005). To determine if firms are demonstrating sustainability and the extent to which corporate actions might benefit future generations, performance should be measured (Atkinson 2000; Epstein & Roy 2001).

Given that the market mechanism as a whole and individual firms in particular are able to prevail in the long-term only if there are healthy finances, measurement of economic viability therefore includes indicators such as growth in profits and earnings per share, forward-looking market measures of long-term prospects (e.g. market-to-book ratio), and other measures such as cash-flow, which is necessary to sustain a firm. Measurement of environmental quality includes aspects such as quantifiable reductions in carbon emissions (both in the focal firm and its supply chain partners) and other potentially hazardous byproducts and waste, reduced material use, demonstrated improvements in energy efficiency, water conservation, and overall minimization of the use of natural capital. Lastly, measurement of social responsiveness includes demonstrated employee training initiatives, upholding fair trade and human rights, improvements in product safety, increased gender balance in executive appointments, reduced health and safety violations, demonstrated equity in wage policies, and investments in communities and regions. In sum, measures such as these gauge the extent to which firms are demonstrating sustainability, and the extent to which future development and long-term value creation might be assured. However, as noted, sustainable firms do not focus exclusively on only one aspect; rather, they strive to demonstrate performance across economic, environmental, and social aspects (Bansal 2005).

BOARDS AND SUSTAINABILITY PERFORMANCE: A MODEL DEVELOPMENT

Boards of directors are at the strategic apex of decision making (Fama & Jensen 1983). This upper echelon position, in theory, gives boards substantial power over how a firm navigates the strategic

landscape for the good of shareholders, but also increasingly for the natural environment and society (Elkington 2006). To explore board level influence on sustainability performance, the human capital of outside directors is explored first.

Human capital of outside directors and the monitoring role

There is increased stakeholder scrutiny and institutional pressure on firms to be more accountable for environmental and social impacts (Meyer & Kirby 2010). This level of influence may or may not be recognized by the board or may not be seen as being as important as economic concerns. The reason for this is that generally speaking, inside and outside directors have different interests, goals, and time horizons. Inside directors, because of their close ties to agents or their own insider interests, are more likely to be attentive to short-term economic goals. Further, insiders are less likely to advocate investments in environmental or social strategies, particularly if they conflict with economic goals or reduce short-term economic performance. However, sustainability requires a long-term horizon and may involve short-term costs to achieve long-term goals (Hahn, Figge, Pinske & Preuss 2010). There is evidence to suggest that outside directors may be more attuned to long-term horizons as well as being more accepting of short-term losses for the benefit of long-term interests (Johnson & Greening 1999).

Some research exploring the relationship between boards of directors and matters related to sustainability suggests that boards with a higher percentage of outside directors are positively related to various measures of environmental and social performance (Ibrahim & Angelidis 1995; Johnson & Greening 1999; Webb 2004). However, research into the influence of board composition on sustainability performance has thus far been inconclusive. For example, contrary to the findings of Ibrahim and Angelidis (1995) and Webb (2004), other research suggests that inside directors are positively associated with particular aspects of sustainability performance (Coffey & Wang 1998; Wang & Coffey 1992). More recently, Bear, Rahman and Post (2010) examine the relationship between diversity in human capital of inside and outside directors and firms' social performance, finding an insignificant effect. A possible explanation for such contradictory or inconclusive findings is previous studies' lack of focus on specific or *exclusive* types of outside directors. More specifically, it is posited that the extent to which boards monitor

managements' performance on sustainability is influenced by the human capital offered by two specific outside director types: support specialists and community influentials (Hillman, Cannella & Paetzold 2000).

Support specialists lack general management expertise but offer specialized experience in given areas. Such expertise can include law, the capital markets, public relations, marketing, etc. (Hillman et al. 2000). According to Hillman et al. (2000), support specialists are vital to boards because they offer information about environmental contingencies and provide critical input difficult to obtain elsewhere. Support specialists also offer unique perspectives that are difficult to obtain from inside directors, such as in industries whose competitive environments are tightly controlled (Hillman et al. 2000). On the other hand, community influentials, like support specialists, are also important because they provide necessary non-business perspectives on proposed actions and strategies as well as have influence with powerful groups in society (Baron 1995; Hillman, Cannella & Harris 2002). Community influentials are more likely to discount a 'pure' business or competitive orientation, while offering advice and insight on non-business orientated stakeholders. Community influentials generally consist of outside board members with backgrounds and experience in politics, community groups, NGOs, universities, and other social organizations and enterprises.

In sum, inside directors are expected to be motivated to ensure the firms they oversee are meeting economic goals. However, when complemented with outside directors who are support specialists and community influentials, a firm's environmental and social performance is expected to be monitored and improved. Further, when firms neglect their environmental or social performance, consequences can be severe, particularly with respect to negative media attention and a loss of legitimacy in society (Bansal 2005; Haanaes et al. 2011; Scherer & Palazzo 2010). The literature acknowledges that there are reputational consequences of bad performance—economic or otherwise—not only for firms, but for individual directors as well (Cowen & Marcel 2011; Fama 1980; Fama & Jensen 1983). Outsiders who are support specialists and community influentials have an incentive to monitor, intervene, and correct poor

performance on environmental and social dimensions not only because of a reputational motivation, but because their experiences are best placed to effectively monitor management in these areas. Therefore:

Proposition 1: Boards with a high proportion of outside directors who are support specialists and community influentials are more likely to monitor the extent to which management is demonstrating sustainability performance. This monitoring role has a positive influence on the future sustainability performance of the firm.

Social capital of outside directors and the resource provision role

In addition to their human capital, the social capital of outside directors is an important source of ‘access to timely information, diverse ideas, and critical...resources’ (Oh, Labianca & Chung 2006, p. 578). Simply put, social capital arises through director interlocks, or when an outside director affiliated with one organization sits on the board of directors of another organization (Hillman & Dalziel 2003). Generally, outside directors serve on the boards of other firms. These board interlocks are important to build the social capital needed to fulfill the resource provision function (Pfeffer & Salancik 1978; Hillman & Dalziel 2003).

In the case of sustainability, insiders would be expected to have substantial knowledge of the firm and the environmental factors facing its industry. Insiders are thus a key source of knowledge of opportunities, threats, competitive conditions, technology, and regulation *within* a specific industry (Kor 2003). While important, this context-specific knowledge can limit creativity in problem solving due to lack of exposure to new or novel ideas outside of the industry (Dutton & Duncan 1987; Ocasio 1997). Given the complexity—if not novelty—of sustainability, I argue that the *type* of interlocks of outside directors is vital to develop the social capital that impacts on sustainability performance.

Sustainability is complex because it demands the *integration* of economic, environmental, and social factors in policy-making (Dovers 1995; Hahn et al. 2010). Yet this level of integration does not come easily. First, sustainability is an emerging business issue in which many unknown parameters exist, and the ability to align an organization to solve its complex challenges is untested for many firms (Berns et al. 2009; Hopkins 2009; Lueneburger & Goleman 2010). Second, insight on how to address sustainability may be limited in some industries as there remains much unquantified risk (Hahn & Figge

2011; Lueneburger & Goleman 2010). Third, sustainability may require tough decisions on trade-offs, such as a decision on making a contribution to sustainability at the *societal* level that may require a minor loss at the *corporate* level (Hahn et al. 2010). However, there is evidence to suggest that under circumstances of complexity, having heterogeneous interlocks (ties to firms in different industries) may be better than having homogeneous interlocks (ties to firms in the same industry) (Rodan & Galunic 2004).

In complex environments, firms often depend on identifying new strategic alternatives that can be influenced by examples outside of the focal industry (Tushman & Anderson 1986). In the case of sustainability, because of its inherent complexity, recognition of and response to the matter can be quite different across industries (Galbreath 2009). Thus, one way that boards can incorporate a more diverse range of resources to address sustainability is through the social capital of outside directors. More specifically, outside directors with ties to boards in industries that differ from that of the focal firm effectively broaden the schemata or knowledge structures that can be brought to bear on their resource provision role. In effect, outside directors with ties to firms in different industries than the focal firm are: (1) likely to channel back to the board a greater range of sustainability-related resources and (2) use these resources to help the firm avoid or counteract excessive managerial commitment to non-sustainability-related strategies. Hence:

Proposition 2: Boards who have outside director interlocks to firms in industries different from the focal firm creates diversity in social capital. This diversity of social capital generates valuable and timely resources that have a positive influence on the future sustainability performance of the firm.

CEO influence on sustainability performance

Taking outside directors' human and social capital as important, any discussion of boards, monitoring and resource provision functions, and firm outcomes must take into account the CEO (Haynes & Hillman 2010; Hillman & Dalziel 2003). The main reason being is that under agency theory, boards monitor management and the CEO represents the pinnacle of management. However, at the board level, because of their position of power, CEOs may be less than accepting of outside directors' monitoring of current management performance or accepting of alternative strategic considerations, advice, or feedback they

provide, especially if altering or challenging current pathways or the *status quo* (Hambrick, Geletkanycz & Fredrickson 1993).

However, recent research suggests that CEOs can demonstrate understanding and adapt to others' advice, perspectives, and criticism even if they diverge from their existing mindsets and perceptions (Nadkarni & Herrmann 2010). This openness permits CEOs to effectively consider a wide range of strategic alternatives, including those that might deviate from current strategies. Thus, CEOs on the board who are more open can consider a broader spectrum of issues in decision making for the firm. I argue that there are two ways CEOs are more likely to be open or receptive to discussions of sustainability in the boardroom: first, their human capital and second, the influence of their social capital.

CEO human capital. Upper echelons theory posits that characteristics of top managers explain, in part, firm strategy and organizational outcomes (Hambrick & Mason 1984). One primary influencer is the functional backgrounds of top managers (Hambrick & Mason 1984). Functional specialization of top managers can bias the definition and influences the course of action adopted in an organizational setting. Although Hambrick and Mason (1984) acknowledge that functional backgrounds may not totally dominate strategic choices, they nonetheless can be expected to exert significant influence.

In the case of CEOs, although they can be presumed to have a generalist's view, they often bring an orientation developed in their primary functional area (Hambrick & Mason 1984). Specifically, CEO functional experience is an important indicator of the cognitive biases and types of knowledge that they bring to the board, and provides a lens through which business problems and solutions are often identified and defined (Herrmann & Datta 2002). CEOs with 'peripheral' backgrounds (accounting, finance, law) (Westphal & Milton 2000) are likely to be biased towards control and efficiency. This could be problematic with respect to sustainability as there is much unquantified risk and uncertainty surrounding the paradigm (Dovers 1995; Lueneburger & Goleman 2010). On the other hand, CEOs with 'output' backgrounds (marketing and sales, R&D, engineering) (Tuggle, Schnatterly & Johnson 2010) are more attuned to the dynamics of the market and stakeholder requirements, such as those impacting sustainability (Galbreath 2010). CEOs with output backgrounds are also better than other background types in dealing

with situations involving greater ambiguity and more uncontrollable factors (Gupta & Govindarajan 1984), which is the case of sustainability. As Bansal (2005, p. 202) notes, sustainability 'is marked by considerable uncertainty because of changing expectations, the complexity of the problem, and the difficulty of its resolution'. Hence:

Proposition 3: A board with a CEO who has significant 'output' background experience is more likely to accept: (1) monitoring of outside directors on the effectiveness with which current management addresses sustainability and (2) resources from outside directors that might be relevant to addressing sustainability. This 'output' background experience of a CEO has a positive influence on the future sustainability performance of the firm.

CEO social capital. CEOs on boards are a key provider of company ('inside') information and information on the competitive context to the board. An understanding of the competitive context can come through board ties with other firms. Generally, CEOs set on the board of at least one other company (McDonald & Westphal 2010); such external ties influence the development of their social capital. For example, CEOs who serve as outside directors can learn about the efficacy of new approaches to business, strategies, and implementation issues by observing first-hand the consequences of management decisions at other firms. Moreover, learning derived from CEO interlocks is particularly valuable in that it reflects the recent experience of his contemporaries, who face similar macro-economic threats and opportunities and socio-political issues. However, unlike the social capital of outside directors (*heterogeneous* interlocks), I posit that CEO social capital that is influenced by firms in the same industry is most important (*homogeneous* interlocks).

A CEO's framing of an issue such as sustainability will be shaped by the extent to which he observes firms in the same industry who are themselves demonstrating success with sustainability initiatives. Following Burt (1987), a CEO who considers adopting a practice such as sustainability is most likely influenced by adopters to whom he is structurally equivalent; that is, to whom he shares a similar social role or social position within the network. Given that CEOs often belong to industry associations and other forums of industry interest (Haunschild & Beckman 1998), they develop strong social standing with their industry peers. This structural equivalency helps facilitate the exchange of firm-centric information and resources that can help in problem solving and decision making within the industry.

Moreover, because of structural equivalency, CEOs with interlocks to firms in the same industry who demonstrate success with sustainability are likely to increase the acceptance that sustainability is a valid approach, as familiarity with others in similar circumstances increases the willingness to accept new strategic approaches or adopt new innovations (DiMaggio & Powell 1983).

Because firms are risk adverse (Lavery 1996), CEOs have motivation to protect current strategies and to carefully scrutinize any new direction that diverges from established trajectories. However, when CEOs directly observe sustainability success stories in their own industry through intra-industry interlocks, they gain a sense of legitimacy of the practices worthwhile to emulate in their own firms. Further, having a good mix of director interlocks to similar firms (e.g. CEO interlocks to firms in the same industry) *and* dissimilar firms (e.g. outsider director interlocks to firms in different industries than the focal firm) may create an optimal portfolio of social capital. Therefore:

Proposition 4: A CEO on the board who has interlocks to firms in the same industry that have demonstrated successful sustainability strategies increases the social capital needed to address sustainability in the focal firm. The flow-on resources from this focused level of social capital has a positive influence on the future sustainability performance of the firm.

The moderating influence of value attunement

Business takes place within a cooperative social context (Ghoshal 2005) and in recent times, complex social matters have arisen (Galbreath 2009 2011a). In fact, an underlying driver of the need for firm response to sustainability is societal norms, values, and expectations, which are reflected in a growing number of social issues that directly relate to sustainability (Galbreath, 2009 2011a). Within the business and society literature, scholars have addressed the social issues concept (Lamertz, Martens & Heugens 2003). Social issues are those that are problematic to society and have an ability to influence government or corporate policy (Mahon & Waddock 1992). Galbreath (2011a) notes the variety of social issues underlying the need for business to respond to sustainability; however, as Swanson (1999) demonstrates, how decision-makers view social issues—and the underlying societal norms, values, and expectations that are focusing attention on them—can vary. For purposes here, I focus on normative and descriptive perspectives.

Responses to social issues are framed by what firms should or should not do on behalf of the social good or by what they do or can do (Wood 1991). What firms should or should not do follows a normative approach, and is centred on moral evaluation, judgement, and prescription of human action (Treviño & Weaver 1994). What firms do or can do follows a descriptive approach, and is centred on explanation, measurement, and prediction (Treviño & Weaver 1994). Hence, normative approaches are grounded in values; descriptive approaches are grounded in fact and empiricism. Both have implications for individual decision makers.

Decision makers who face sustainability, societal values, and relevant social issues in a descriptive manner can suffer from myopia. Such normative myopia arises because values are either removed from decision-making or are not effectively examined or adequately enacted (Swanson 1999). Descriptive approaches to decision-making therefore generally focus on profit maximization, because this is presumed to be what a corporation *does*, and responding to social issues is generally ignored, is made subservient to financial considerations, or is seen as outside the scope of a firm's objective (Freeman & Gilbert 1992). Directors who ignore the role of values, or who make a strict separation of values and facts in decision-making, can therefore put the firms they govern at risk of neglecting stakeholders, and the power and influence they can wield over corporate resources. Swanson (1999) refers to this phenomenon as *value neglect*.

Conversely, directors who display an awareness of their personally held values, while at the same time giving due consideration to values held by others, position themselves to be receptive to the social issues surfaced through various stakeholder demands and interests, a concept Swanson (1999) refers to as *value attunement*. In this case, not only are director's personal values enacted, but there exists an awareness of and responsiveness to the values of corporate stakeholders and the values of other societal constituents. Hence, the work of Swanson (1999) suggests that values can affect the magnitude and direction of the relationship between board capital and task performance. Given the monitoring and resource provision roles of boards, the expectation is that in boards where *all* directors do not adequately align personal and societal values may have less influence on sustainability performance than what might

otherwise be expected, given the previous discussions on outside director and CEO human and social capital.

I therefore posit that value attunement facilitates board decision-making that responds positively to the social issues that drive the need for action on sustainability. Where a board's directors demonstrate value attunement, the expectation is that they will integrate an exclusive fiduciary relationship with shareholders with a moral relationship with other stakeholders, committing to the welfare, growth, and wholeness of all stakeholders while honouring the citizenship duties of the corporation to society. This further strengthens the degree to which monitoring and resource provision roles are directed towards meeting sustainability demands. Thus:

Proposition 5: The greater the value attunement amongst all directors the stronger the relationship between board capital and monitoring and resource provision roles relative to sustainability. Value attunement therefore increases the impact of monitoring and resource provision on the future sustainability performance of the firm.

DISCUSSION AND CONCLUSION

I have argued that to ensure monitoring and oversight of sustainability is fulfilled at the board level, specific forms of board capital are necessary. The human capital of two specific types of outside directors (support specialists and community influentials) stimulates the knowledge and experience that is necessary to monitor management's performance on sustainability. Breadth in social capital of outside directors, which results from their ties to firms in different industries than the focal firm, brings back to the board necessary resources to advise and offer counsel on effective sustainability strategies. However, powerful CEOs can undermine the value of the board capital of outside directors. The model demonstrates that the type of human and social capital of CEOs is therefore an important determinant in the extent to which they will be receptive and open to monitoring and counsel on sustainability matters, especially from outside directors.

Contrary to much research on corporate governance, the model also recognizes the importance of values as a moderating factor in the extent to which boards impact sustainability. Sustainability by nature challenges firms to consider what they should do with respect to addressing a corporate imperative beyond just an economic mandate (Elkington 2006). Because the natural environment and broader societal concerns are considered,

sustainability requires a normative approach to business and to decision-making. The model demonstrates that Swanson's (1999) concept of value attunement should be accounted for. Hence, following the call to explore contingency models in corporate governance research (Pettigrew 1992), the model takes into account intervening variables that are likely to moderate the extent to which boards of directors impact on firm performance, economic or otherwise.

As for empirical testing, existing studies demonstrate that board capital is readily available, namely through sources such as director profiles in governance sections of annual reports (e.g. Haynes & Hillman 2010). Researchers could collect data on human and social capital as specified in the propositions put forth in this paper. Although sustainability is yet to have a universal definition or operationalization, studies suggest that proxies can be captured both through the use of surveys and secondary data, such as annual reports, supplemental reports (e.g. sustainability reports), or through third party evaluators such as Sustainalytics (e.g. Bansal 2005; Galbreath, 2011b). Lastly, the concept of value attunement has yet to be operationalized. However, a thorough examination of Swanson's (1999) concept suggests that one way researchers could measure value attunement is through developing Likert scales to be used in a survey of corporate directors. Of key interest is studying the longitudinal effects of all constructs, which would require at least three to five years of performance data.

In conclusion, the goal of this paper has been to develop an improved framework for researching the role that boards play in improving firms' strategic responses to the growing sustainability concerns of stakeholders, the environment, and society. While there are many avenues through which firms may pursue improved sustainability performance, the paper suggests that boards' human and social capital and value attunement should be recognized as important and essential elements in any effective program for improving a firm's ability to sense and respond to sustainability concerns. I hope that this discussion points the way to new and better approaches to improving the sustainability performance of firms—on which the long-term viability of our economies, societies, and the natural environment depends.

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FIGURES

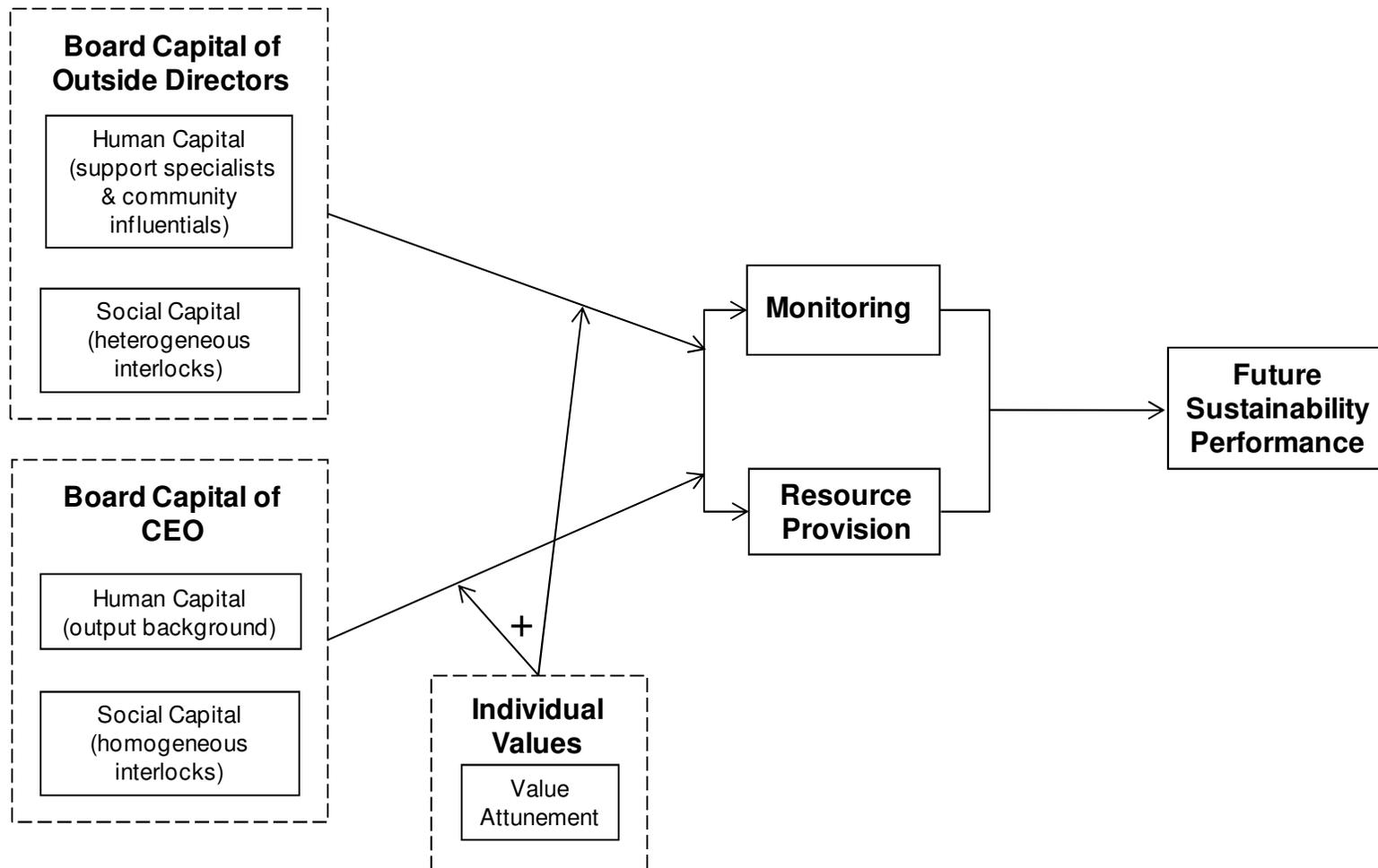


Figure 1. Conceptual model