Exporters to countries that value CEO power will have more powerful CEOs

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Corporate governance scholars have long argued that a board of directors can serve a legitimising role for their organisation. But strong CEO power, in their view, can be de-legitimating because of its non-compliance with “good governance” principles.

By legitimacy, in corporate governance terms, we mean that there is a perception that the actions of the organisation conform to or are appropriate within some socially constructed system of values. Whose perception is important here? Typically, scholars identify investors, analysts, and regulators as the key audiences.

However, there is a sense that the expectations of customers, especially those outside the firm’s home country, may be equally important for its corporate governance development. Legitimacy in the eyes of customers becomes even more important to consider when their standards of legitimacy are not aligned with those enshrined in the firm’s home country. At present, understanding of the link between governance characteristics and the demand-side legitimation process is limited.

The dominant corporate governance logic has crowded out consideration of non-stockholder related external assessors. Yet this group possesses great power to confer legitimacy on a firm, and may potentially view CEO power very differently to financial market participants. Indeed, they may view a strong and powerful leader as more legitimate than one dominated by a strong board. Customer participation is indispensable to a firm’s continued existence, and little research has so far examined the role the customers can play in shaping the firm’s governance.

To explore the potential for customers’ influence on corporate governance decisions, we set out to investigate whether companies alter their CEOs’ power to match the cultural expectations of their customers. Specifically, we hypothesised that firms selling their products in foreign markets characterised by high respect for power will exhibit greater CEO power on their boards, because a strong CEO carries more legitimacy among the firm's customers.

To test this hypothesis, we collected data from 151 publicly traded U.S. semiconductor and pharmaceutical firms over a ten year period. We constructed a weighted-average measure of a firm's "demand-side cultural power distance", essentially the extent to which the firm sells predominantly in countries with high respect for power. The data confirmed our expectation: firms that compete heavily in high-power distance cultures are more likely to have powerful CEOs.

We also predicted that this effect would be stronger for firms in greater need of establishing or maintaining cultural legitimacy. Specifically, we predicted that the link between demand-side cultural power distance and CEO power would be stronger for firms doing business in a more concentrated group of countries, for firms doing business in a more homogeneous group of countries, and for semiconductor firms relative to pharmaceutical firms.

The logic for these predictions was as follows. The fewer countries in which a firm does business, the more important it is to demonstrate legitimacy in those countries. Similarly, the more culturally homogeneous the countries are in which a firm does business, the more salient cultural attributes — like respect for power — will be in firm decision-making.

Finally, because pharmaceutical firms tend to be more monopolistic with branded products that are difficult to imitate, we expected them to be less reliant on legitimacy with their customers than semiconductor firms are. The data confirmed these three predictions as well.

Thus, we are able here to address CEO power and legitimation of the firm in the eyes of customers. We focus specifically on customers' home culture and how that culture will affect legitimacy judgments of the firm. Thus, we demonstrate how firms seek to match their CEOs' power with the legitimacy standards that are dominant in the geographic regions in which they compete for sales, even when high CEO power contradicts the agency-driven perceptions of the investor community at home.

We hope this study prompts further consideration of demand-side/customer driven legitimacy in theoretical research of board phenomena. The study challenges traditional views of governance as a main driver of the firm's strategy by suggesting that board configurations themselves may be an outcome of strategic decisions of the firm related to its choice of markets. For example, the most recent corporate governance initiatives focus on increasing board diversity, including diversity of gender composition. Our study suggests that firms might face some difficulties implementing this initiative if they conduct business in countries with high masculinity cultures. Further, social pressures stemming from demand-side legitimacy may not be aligned with the demands of equity markets, as well as regulatory guidelines.

As the recent scandals involving tax avoidance by the largest blue-chip companies clearly indicate, efficiency-driven strategies, albeit within the scope of full compliance with legal rules and regulations, may cause a serious backlash when companies ignore possible consequences associated with social, normative expectations from customers and other stakeholders. In turn, this failure to recognize legitimacy arguments may be followed by an introduction of much tougher regulations by the government.

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Notes:

- *This blog post is based on the authors' paper When in Rome, Look Like Caesar? Investigating the Link between Demand-side Cultural Power Distance and CEO Power, in Academy of Management, August 2016, vol. 59, no. 4 1361-1384*
- *The post gives the views of the author, not the position of LSE Business Review or the London School of Economics.*

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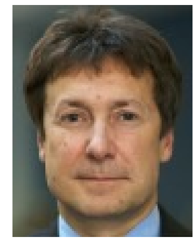

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