IMPACT OF EXTERNAL ENVIRONMENT ON ORGANIZATIONAL STRUCTURE

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ABSTRACT

This paper examines the impact of the external environment on the organizational structure of boards of directors. . It investigates the impact of regulations on the organizational structure of boards of directors of financial institutions in view of recent changes in such regulations as a result of the requirements arising from the Sarbanes-Oxley Act of 2002, and the Financial Services Act of 1999 (also known as Gramm-Leach-Bliley Act). The regulatory environment is expected to affect the board size, number of independent directors, and number of board committees.

External environment and board structure

Regulation is an important aspect of the external environment. Organizations respond to regulation in a variety of ways. One way is through their boards of directors. Boards are legally responsible and accountable for the actions of their organizations, and are the most visible structural component of organizations. This study examines the impact of regulations on the organizational structure of boards of directors of financial institutions in view of recent changes in such regulations as a result of the requirements arising from the Sarbanes-Oxley Act of 2002, and the Financial Services Act of 1999 (also known as Gramm-Leach-Bliley Act). To understand the effects of regulation on board structure, it is first necessary to examine the role of corporate boards and their relationship to organizational legitimacy.

Regulation and government policy are important and critical elements in the environment of any organization (Shaffer,1995; Hillman, Zardkoohi, & Bierman, 1999). Highly regulated firms tend to be more visible and to be held more accountable for their activities than less regulated firms. Their activities are likely to have a substantial impact on the economy, and they enjoy a degree of protection from competition and market forces. Because of the attention they receive, the potential impact of their actions, and the special privileges they enjoy, highly regulated firms have a greater need to maintain legitimacy than less regulated firms. Since maintaining legitimacy is a primary function of corporate boards, the board is expected to be adapted to the firm's regulatory environment and to its associated legitimacy needs. The structural implications for boards follow from the previous discussion of legitimacy and board structure. Firms in more highly regulated industries are expected to have larger boards, and a higher percentage of outside directors. Cooptation as a means to gain legitimacy was discussed above. A second use of cooptation is to gain the support of external organizations and interest groups which have power or greatly influence the organization business. Typically, such support is accomplished through the use of outside board directors to create linkages between organizations and certain critical elements of their external environments. Resource dependence scholars postulate that the extent of such linkages is a function of the types and levels of dependence needed by an organization (Pfeffer and Salancik, 1978; Boyd, 1990; Hillman, 2005). This use of cooptation is a political tactic directed toward specific external actors. Regulatory agencies have government-granted power over firms in the industries they regulate. These powers vary by industry, but include the ability to control entry, set

rates, and mandate the terms and conditions of operation. Although regulators are legally forbidden from sitting on the boards of firms in the industries they regulate, these firms can still use cooptation to influence regulatory policies (Lang & Lockhart, 1990). They can accomplish this by adding board members who possess political, social, or economic power that is of concern to the regulators. As Pfeffer (1972:222) observed, "tapping these bases of power and influence requires coopting a relatively large number of external representatives." In a recent study, Hillman (2005), found that boards of heavily regulated firms have more politician directors than those of less regulated firms. Likewise, institutional theory scholars suggest that organizations understand that displaying conformity to their regulatory environments can generate considerable advantages, such as greater legitimacy, more resources, and better performance (Scott, 1995). Consequently, firms in more highly regulated industries are expected to have larger boards and a higher percentage of outside directors. The theoretical perspectives considered here are complimentary. Considerations of pursuing legitimacy through structural conformity and through cooptation and of using cooptation as a political tactic to influence regulatory agencies lead to the same predictions for the effects of regulation on board size and outsider percentage. The legitimating strategy of structural conformity reinforces the prediction for independent directors. A number of scholars found positive effects of firm size on board size (Pfeffer,1992; Harrison, 1986, Boyd, 1990, Dalton, Daily, Ellstrand & Johnson, 1998). Larger firms are also expected to have more board committees. One reason is that they have greater legitimacy needs, so are more likely to conform to structural norms for board committees. A second reason is that business is likely to be more complex for larger firms, and committees can help the board to deal with complexity more effectively (Koontz, 1967). Firm performance can also have an effect on board structure (Boyd, 1990; Dalton et al., 1999; Hillman, 2005). Poorly performing firms are more likely to face critical resource dependencies and strong demands from interest groups with a stake in firm performance. Their performance inadequacies can lead to greater legitimacy needs. Consequently, these firms are expected to use the structural conformity, leading to larger boards and a higher percentage of independent directors. In related studies, a measure of financial pressure, the debt-equity ratio, was found to be positively related to board size (Pfeffer, 1972) and to the percentage of outsiders (Pfeffer, 1972; Pennings, 1980; Harrison, 1986), and Harrison, Torres, and Kukalis (1988) found that poor performance led to the structural separation of the board chair/CEO position.