ORGANIZATIONAL DISCRETION, BOARD CONTROL, AND SHAREHOLDER WEALTH: A CONTINGENCY PERSPECTIVE

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This is the peer reviewed version of the following article:

Ponomareva, Yuliya, Wei Shen, and Timurs Umans. "Organizational discretion, board control, and shareholder wealth: A contingency perspective." *Corporate Governance: An International Review* 27.4 (2019): 248-260.

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ABSTRACT

Manuscript Type: Conceptual

Research Question/Issue: How does organizational context influence the impact of board control over managerial decisions on shareholder wealth?

Research Findings/Insights: We introduce a new theoretical concept—organizational discretion—to characterize the upper limit of managers' latitude of actions presented by their organizational context, and propose that it moderates the impact of board control on shareholder wealth. Specifically, we first argue that strategic control by boards over managerial decisions reduces managers' latitude of actions and leads to trade-offs between the containment of managerial opportunism and the pursuit of strategic opportunities, which consequently influence the relationship between strategic control and shareholder wealth. We then suggest that the trade-offs incurred by strategic control over managerial decisions are more prominent in firms with high organizational discretion. Because of the trade-offs, we propose that boards are likely to decide whether to rely more on strategic control or financial control in internal corporate governance based on their firms' level of organizational discretion.

Theoretical/Academic Implications: By introducing the concept of organizational discretion and highlighting the trade-offs caused by boards' strategic control over managerial decisions, we advance a contingency perspective to enhance the understanding about the impact of board control on shareholder wealth. It also bridges the strategic management and corporate governance research on managerial discretion that has largely evolved separately in the literature.

Practitioner/Policy Implications: Boards should attend to the trade-offs between the containment of managerial opportunism and the pursuit of strategic opportunities when exercising strategic control over managerial decisions. Moreover, considering the trade-offs involved, boards should carefully design and implement internal corporate governance mechanisms based on their firms' level of organizational discretion.

Keywords: Corporate Governance, Board of Directors, Strategic Control, Managerial Discretion, Organizational Discretion, Firm Performance

INTRODUCTION

In response to a series of high-profile corporate scandals in the early 2000s, new rules, regulations, and codes of good governance have been introduced and implemented worldwide (Adams, Hermalin & Weisbach, 2010; Aguilera & Cuervo-Cazurra, 2004; Finegold, Benson & Hecht, 2007; Finkelstein, Hambrick & Cannella, 2009). Many of these changes are intended to increase the boards of directors' independence and power while reducing managers' decision-making authority and autonomy so that the boards can exert greater control over managerial decisions (Adams et al., 2010; Finegold et al., 2007). However, empirical studies thus far have not provided consistent evidence suggesting that increased board control over managerial decisions has a positive effect on shareholder wealth (Boivie, Bednar, Aguilera & Andrus, 2016; Hambrick, Misangyi & Park, 2015).

In this article we attempt to advance the understanding about the impact of board control over managerial decisions on shareholder wealth by attending to the influence of organizational context. Specifically, we introduce a new concept—organizational discretion—to describe managers' latitude of actions presented by their firms' industry and organizational characteristics, and propose that it moderates the impact of board control on shareholder wealth. The literature on managerial discretion (Hambrick & Finkelstein, 1987; Williamson, 1963) suggests that strategic control by boards over managerial decisions limits managers' latitude of actions (Shen & Cho, 2005). Although limiting managers' latitude of actions helps to contain their opportunistic behaviors (Fama & Jensen, 1983; Williamson, 1963), we argue that it can also lead to strategic opportunity costs because it inhibits a firm's ability to capitalize on managers' expertise in the pursuit of strategic opportunities. Thus, the overall effect of boards' strategic control over managerial decisions on shareholder wealth depends on the trade-offs between the containment of managerial opportunism and the pursuit of strategic opportunities. As the level of boards' strategic control over managerial decisions increases, we contend that the strategic opportunity costs incurred can exceed the benefits gained from the containment of managerial opportunism, resulting in an aggregated loss in shareholder wealth.

We further argue that the strategic opportunity costs incurred by boards' strategic control over managerial decisions are particularly prominent in contexts of high organizational discretion. According to Hambrick and colleagues (e.g., Crossland & Hambrick, 2007, 2011; Hambrick & Finkelstein, 1987; Quigley & Hambrick, 2014), managers can have a greater positive impact on firm performance when they have high latitude of actions (Shen & Cho, 2005). In our conception, organizational discretion refers to the range of strategic options presented by a firm's industry and organizational characteristics such as industry structure, market growth, firm size, and resource availability. For a given manager, it sets the upper limit of the manager's discretion in latitude of actions (Shen & Cho, 2005), which will then be reduced as the level of board control over managerial decisions increases. Compared to firms with low organizational discretion where managers' latitude of actions is very limited, we argue that in firms with high organizational discretion, strategic control by boards over managerial decisions is likely to incur greater strategic opportunity costs because it can have a stronger inhibiting effect on the firms' ability to capitalize on managers' expertise in the pursuit of strategic opportunities. As a result, strategic control by boards over managerial decisions tends to have a stronger negative effect on shareholder wealth in firms with high organizational discretion than in firms with low organizational discretion.

We then suggest how the trade-offs arising from board control over managerial decisions influence a firm's internal governance mechanism and performance. We expect that boards of firms with high organizational discretion are likely to limit the level of strategic control over managerial decisions to avoid incurring significant strategic opportunity costs, while relying more on financial control of managerial incentives to align managers' interests with those of shareholders. In contrast, because firms with low organizational discretion have limited strategic opportunities, boards of these firms are likely to be more concerned with the containment of managers' opportunistic behaviors than the pursuit of strategic opportunities. We thus expect them to rely more on strategic control over managerial decisions than financial control of managerial incentives in internal governance. We also propose that firms whose internal governance mechanisms are more aligned with their levels of organizational discretion tend to have higher performance than firms whose internal governance mechanisms are less aligned with their levels of organizational discretion.

Our paper makes several contributions. First, it contributes to the literature about the impact of board control on shareholder wealth. Although Jensen and Meckling (1976), in their seminal work on agency theory, acknowledge that limiting managers' decision-making power can result in costs because it weakens managers' ability to capture profitable opportunities, they do not elaborate on this issue, particularly regarding whether and how these costs vary across different organizational contexts. Subsequent research, with a few exceptions (e.g., Hoskisson, Castleton & Withers, 2009; Knapp, Dalziel & Lewis, 2011; Westphal, 1999), primarily focuses on the benefits of board control on the containment of managerial opportunism (Baysinger & Hoskisson, 1990; Dalton, Hitt, Certo, & Dalton, 2007; Fama & Jensen, 1983; Hermalin & Weisbach, 1998; Walsh & Seward, 1990). By explaining why board control over managerial decisions can incur strategic opportunity costs and aggregated loss in shareholder wealth, particularly in firms with high organizational discretion, we provide a more complete view about the effect of board control on shareholder wealth. In this regard, our paper has also implications for research on board involvement in strategic decision-making (McNulty & Pettigrew, 1999; Ravasi & Zattoni, 2006).

Second, our paper contributes to the literature on managerial discretion by introducing the concept of organizational discretion and explaining how it influences corporate governance. Managerial discretion has received increasing attention in strategic management research because it contributes to the understanding of managers' impact on firm strategies and performance (Crossland & Hambrick, 2007, 2011; Finkelstein et al., 2009; Hambrick & Finkelstein, 1987; Quigley & Hambrick, 2014). However, its implications for corporate governance have not been adequately addressed (Wangrow, Schepker & Barker, 2015). While organizational economists have long recognized the importance of managerial discretion in corporate governance (Jensen & Meckling, 1976; Lang, Poulsen, & Stulz, 1995; Williamson, 1963), they largely treat it as a factor giving rise to managerial opportunistic behaviors and focus on its reduction through board control over managerial decisions (Fama & Jensen, 1983; Shen & Cho, 2005). Our paper bridges these two separate streams of literature by attending to how strategic control by boards limits managers' latitude of actions in the pursuit of strategic opportunities and how organizational discretion influences internal corporate governance mechanisms.

We organize the rest of the paper as follows. We start with introducing the concept of organizational discretion, with an emphasis on how it is related to but different from managerial discretion. We then explain why strategic control by boards over managerial decisions can lead to strategic opportunity costs and aggregated loss in shareholder wealth, followed by propositions about the moderating effect of organizational discretion in the relationship between board strategic control and shareholder wealth. Next, we predict how organizational discretion influences boards' choice between strategic control over managerial decisions and financial control of managerial incentives in internal corporate governance. We conclude with a discussion of our paper's implications for corporate governance research and practice.

ORGANIZATIONAL DISCRETION

The concept of organizational discretion we introduce is directly related to but different from the concept of managerial discretion. Scholars in both organizational economics and management use managerial discretion to describe the discretion managers have in organizational decision making, but with different focuses (Finkelstein & Peteraf, 2007; Shen & Cho, 2005). Organizational economics scholars, concerned with agency problems arising from the separation of ownership and control, have viewed managerial discretion as an enabler of managerial opportunism (e.g., Jensen & Meckling, 1976; Williamson, 1963). In contrast, management scholars, in an effort to bridge the polar views of organizations as either highly inertial (Hannan & Freeman, 1977) or highly adaptive (Child, 1972; Pfeffer & Salancik, 1978), have used managerial discretion to better understand the degree to which managers can actually influence firm strategies and performance (Hambrick & Finkelstein, 1987; Finkelstein et al., 2009). Recognizing the tension between these two literatures in the use of the term, Shen and Cho (2005: 844) refined the concept of managerial discretion into two distinct dimensions: latitude of objectives and latitude of actions. They used the former to describe the aspect of discretion managers have to pursue personal objectives and the latter to describe "the range of strategic options available to managers as they strive to bring about organizational outcomes demanded by stakeholders."

We define organizational discretion as the latitude of actions (i.e., the range of strategic options) presented by a firm's industry and organizational characteristics such as industry structure, market growth, firm size, and resource availability. According to Hambrick and Finkelstein (1987), the latitude of actions aspect of managerial discretion is not only influenced by a firm's industry and organizational characteristics but also by its board of directors because boards can significantly reduce managers' latitude of actions when they exert strong control over managerial decisions (Shen & Cho, 2005). For instance, boards may restrict managers from undertaking strategic initiatives that explore emerging market trends because they consider these initiatives as risky or unrelated to the firm's current core businesses, even though these initiatives have potential to generate higher returns or enhance the firm's market position in the long term. In our conception, organizational discretion describes the range of strategic options potentially available to a firm before the exercise of decision control by the board of directors. In other words, it represents the upper limit of managers' latitude of actions in the absence of board control over their decisions.[1]

Because managers can have a greater positive impact on firm performance when they have high latitude of actions (Crossland & Hambrick, 2007, 2011; Hambrick & Finkelstein, 1987; Quigley & Hambrick, 2014), we believe that, to better understand how board control over managerial decisions influences firm performance, it is important to distinguish the latitude of actions presented by a firm's industry and organizational characteristics in the absence of board control from the latitude of actions managers actually have in the presence of board control. We thus introduce the concept of organizational discretion to describe the latitude of actions presented by a firm's industry and organizational characteristics in the absence of board control over managerial decisions. According to our conception, organizational discretion represents the maximum latitude of actions potentially available to a manager in a particular organizational context, and managers' actual latitude of actions is jointly determined by both organizational discretion and the extent to which the board exerts strategic control over managerial decisions. In the next section, we explain in detail how board control over managerial decisions influences managers' latitude of actions and shareholder wealth.

BOARD CONTROL AND STRATEGIC OPPORTUNITY COSTS

The literature suggests two types of internal governance mechanisms boards can use to contain managerial opportunism: one is strategic control over managerial decisions, and the other is financial control of managerial incentives (Baysinger & Hoskisson, 1990; Eisenhardt, 1989a; Fama & Jensen, 1983). In strategic control over managerial decisions, boards focus on assessing and approving managers' strategic initiatives before implementation to ensure that these initiatives are in the best interests of shareholders. In this approach, boards directly limit managers' latitude of actions by reducing their decision-making authority and autonomy in choosing from the range of strategic options available to them (Shen & Cho, 2005); managers thus would not be able to undertake strategic initiatives that benefit themselves at the expense of shareholders. In financial control of managerial incentives, boards focus on designing and implementing incentive contracts based on the outcomes of managerial decisions to help align managers' interests with those of shareholders. In this approach, boards attempt to limit managers' latitude of objectives through interest alignment while giving managers latitude of actions in choosing from the range of available strategic options to achieve the performance outcomes set forth by boards (Shen & Cho, 2005).

Despite the existence of these internal governance mechanisms, a vast amount of empirical research suggests that boards have not been able to implement them effectively, at least in the past (Adams et al., 2010; Dalton et al., 2007; Finkelstein et al., 2009). With respect to strategic control over managerial decisions, boards have been found to rarely challenge managerial decisions unless there is a significant decline in firm performance (Alderfer, 1986; Lorsch & MacIver, 1989). With respect to financial control of managerial incentives, studies have consistently shown that managerial compensation is tied to firm size far more strongly than to firm performance (Tosi, Werner, Katz, & Gomez-Mejia, 2000).

Many scholars and advocates of corporate governance reforms attribute boards' lack of effectiveness in protecting shareholder interests to the dominance of managers (Hermalin & Weisbach, 1998; Monks & Minow, 2004). For example, at most U.S. corporations, the CEO also serves as the chairman of the board (Krause & Semadeni, 2013). Such a leadership structure gives the CEO strong power to exert control over board meeting agenda and director selection (Finkelstein & D'Aveni, 1994; Lorsch & MacIver, 1989). Taking advantage of their power, CEOs tend to select directors who are supportive while forcing out those who challenge their decisions

(Hermalin & Weisbach, 1998; Westphal & Zajac, 1995). As a result, boards usually comprise individuals who are friendly and beholden to the CEOs (Westphal & Khanna, 2003), rather than individuals who are independent and who dutifully perform corporate governance on behalf of shareholders (Tosi & Gomez-Mejia, 1989; van Essen, Otten, & Carberry, 2012).

To address this problem of managerial dominance, corporate governance scholars and advocates have increasingly emphasized the need to increase board independence and power while reducing managers' decision-making authority and autonomy (Adams et al., 2010; Dalton et al., 2007; Finegold et al., 2007; Finkelstein et al., 2009; Westphal & Zajac, 2013). Some scholars even urge boards to be more directly involved in strategic decision making, instead of merely advising or monitoring managerial decisions (Deutsch, Keil, & Laamanen, 2007). Corresponding to this trend in academic research, policy makers have initiated reforms with the goal of making boards more active in governance. New rules, regulations, and codes of good governance have been introduced in many countries to stipulate board responsibilities, composition, and behavior (Aguilera & Cuervo-Cazurra, 2004; Finegold et al., 2007; Finkelstein et al., 2009). For example, many major stock exchanges have required boards to have independent audit, nomination, and compensation committees and to hold regular sessions to review managerial decisions without the presence of top executives (Finegold et al., 2007). Shareholder activists and advocates generally applaud these changes as moves in the right direction to enhance board effectiveness in the protection of shareholder interests because they enable boards to increase strategic control over managerial decisions (cf., Adams et al., 2010; Finkelstein et al., 2009).

Although the emphasis of current corporate governance research and practice on increasing boards' strategic control over managerial decisions is understandable and well justified, we would like to caution that it may not necessarily have a positive impact on shareholder wealth as intended because it can reduce managers' discretion in latitude of actions and consequently hinder a firm's ability to capitalize on managers' expertise in the pursuit of strategic opportunities, resulting in what we call "strategic opportunity costs." While the separation of ownership and control creates the potential for managerial opportunism in which managers pursue private interests at the expenses of shareholders, it also enables shareholders to take advantage of professional managers' expertise and increases the efficiency of business decision making in the pursuit of strategic opportunities (Fama & Jensen, 1983; Jensen & Meckling, 1976). The strategy literature has long recognized the importance of managers' latitude of actions in a firm's ability to capture emerging strategic opportunities (Child, 1972; D'Aveni, Dagnino, & Smith, 2010; Hambrick, Cho, & Chen, 1996; Porter, 2004). When boards increase strategic control over managerial decisions, they reduce managers' latitude of actions in making and implementing strategic decisions. Such a change can help contain managerial opportunism (Adams et al., 2010; Baysinger & Hoskisson, 1990; Dalton et al., 2007), but it can also have a negative effect on managerial motivation, the speed of strategic decision making, the quality of communication between managers and directors, and the implementation of the chosen strategies, as we explain in detail below.[2]

First, increase of strategic control over managerial decisions can have a negative impact on managerial motivation, leading to reduced work effort. When boards grant managers decision making authority and autonomy, it signals their trust in managers' competence and professional integrity (Frey, 1993). This trust can promote managerial identification with and commitment to their firms, motivating them to act more as diligent stewards than opportunistic agents (Boivie, Lange, McDonald, & Westphal, 2011; Davis, Schoorman, & Donaldson, 1997). In contrast, when boards increase strategic control by demanding assessment and approval of managerial initiatives before implementation, it indicates distrust in managers. This perceived distrust makes managers less likely to identify with or commit to their firms, demotivating them to work hard on behalf of shareholders (Frey, 1993; Davis et al., 1997; Lange, Boivie, & Westphal, 2015). Moreover, an increase of board control over managerial decisions tends to provoke a salient “us versus them” categorization between managers and directors, making them become more polarized and less cooperative with the other side (Knapp et al., 2011). This polarization can lead to a dysfunctional self-reinforcing cycle, further the development of distrust between boards and managers, and reduce managers’ incentive to act as diligent stewards (Sundaramurphy & Lewis, 2003).

Second, an increase of strategic control over managerial decisions can decrease the speed of strategic decision making. Research shows that unity of command, or concentration of decision-making authority at the top of the firm, generally increases the speed of strategic decision making (Baum & Wally, 2003; Finkelstein & D’Aveni, 1994). In contrast, when such authority is decentralized, it promotes organizational politics and negotiation among the parties involved, decreasing the speed of strategic decision making (Eisenhardt, 1989b). When boards exert strategic control over managerial decisions, it takes time for them to review and approve managers’ strategic initiatives. Given that boards only meet a few times a year, it can significantly slow down the speed of strategic decision making. Moreover, because the authority of strategic initiative approval is shared among a group of directors, it promotes negotiation and politics in the process (Eisenhardt, 1989b), further reducing the speed of strategic decision making (Finkelstein & D’Aveni, 1994).

An increase of strategic control by boards can also have a negative impact on the quality of communication between managers and directors. As we explained above, strong strategic control tends to weaken managers’ motivation, making them less likely to work hard in the best interest of shareholders. Knowing that they do not have the final say in strategic decision making, managers may not be eager to generate innovative strategic initiatives, especially those that, in their estimation, do not have a good chance of winning the board’s approval. When the board questions their initiatives, they may also have little incentive to defend their proposals. Instead, they are more likely to follow industry norms and be prone to modify their proposals to the preference of the board. As a result, their professional knowledge and expertise are underutilized. In addition, there is evidence that CEOs become less likely to share with the board their strategic concerns or to seek strategic advice from the board when their decision-making authority and autonomy is weakened by increasing board oversight and control (Westphal, 1999). These changes in managerial behavior can further undermine the quality of communication between managers and directors by limiting the board's access to important strategic information, consequently hindering the firm's ability to take advantage of the board's human and social capital in the strategic decision-making process.

Lastly, an increase of strategic control over managerial decisions can have a negative impact on strategy implementation. Clear, unambiguous leadership at the top of the firm is important for strategy implementation because it gives the CEO strong control over resource allocations within the firm, enabling him/her to implement the chosen strategies more effectively (Hambrick & Finkelstein, 1987). The unity of command at the top can also facilitate strategy implementation by assuring external stakeholders such as suppliers and clients that the CEO is in control of the firm's strategic direction, thus making them more willing to cooperate with the firm (Hambrick & D'Aveni, 1992). In contrast, strong board control over managerial decisions compromises the unity of command and weakens the CEO's authority, making it difficult for the CEO to implement strategic actions within the firm because other managers may challenge the CEO over resource allocation decisions (Finkelstein & D'Aveni, 1994). Moreover, given the existence of internal competition for the CEO position (Ocasio, 1994; Shen & Cannella, 2002), the compromised authority of the CEO may promote destructive dynamics and more conflicts within the top management team, further impeding effective strategy implementation. Meanwhile, it can also weaken the legitimacy of managers to external stakeholders such as major suppliers and customers whom the firm is dependent on, making the firm less able to obtain resources and support from these important external stakeholders (Hambrick & D'Aveni, 1992).

Because an increase of strategic control over managerial decisions can weaken managers' motivation, decrease the speed of strategic decision making, lower the quality of communication between managers and directors, and hinder the implementation of chosen strategies, it is likely to put the firm at a competitive disadvantage in the race of seeking and capturing emerging strategic opportunities. Weakened motivation reduces managers' desire and efforts to actively seek profitable strategic opportunities or generate innovative strategic initiatives. Together with decreased speed in strategic decision making, lowered quality of communication between managers and directors, and ineffective implementation of the chosen strategies, it undermines the firm's ability to capitalize on managers' professional expertise in the pursuit of profitable strategic opportunities (D'Aveni et al., 2010; Eisenhardt, 1989b; Porter, 2004), ultimately leading to strategic opportunity costs. The greater the board exerts strategic control over managerial decisions, the higher the strategic opportunity costs it will lead to.

Proposition 1. An increase of strategic control by the board over managerial decisions leads to an increase of strategic opportunity costs.

Meanwhile, we acknowledge that increased strategic control over managerial decisions can help contain managerial opportunism, as suggested by agency theorists (Adams et al., 2010; Dalton et al., 2007; Fama & Jensen, 1983). When boards exert stronger strategic control over managerial decisions, they proactively assess managers' strategic initiatives in terms of whether such initiatives are in the best interests of shareholders. Thus, they can help reduce the costs of managerial opportunism by approving only strategic initiatives that they believe will serve shareholders' interests. Given that an increase of strategic control by the board over managerial decisions can both incur strategic opportunity costs and reduce the costs of managerial opportunism, its effect on shareholder wealth depends on the trade-offs between the strategic opportunity costs incurred and the reduction in the costs of managerial opportunism. When the strategic opportunity costs incurred are greater than the reduction in the costs of managerial opportunism, an increase of strategic control by the board over managerial decisions will lead to losses rather than gains in shareholder wealth.

Given the trade-offs involved between the containment of managerial opportunism and the incurrence of strategic opportunity costs, it is important for us to explain in detail how strategic control exercised by the board over managerial decisions influences shareholder wealth. According to agency theory, maximization of shareholder wealth means to maximize shareholders' residual claims of firm profits (Fama & Jensen, 1983; Jensen & Meckling, 1976). In our conception, both strategic opportunity costs and costs of managerial opportunism represent losses to shareholders' residual claims. To understand how strategic control by boards influences shareholder wealth, we need to understand how strategic control by boards influences the aggregated loss to shareholders' residual claims due to both strategic opportunity costs and costs of managerial opportunism. Overall, we expect strategic control by boards to first decrease the aggregated loss and then increase it when the level of strategic control reaches beyond a certain point, as illustrated in Figure 1.

Insert Figure 1 about here

In Figure 1, we have three curvilinear lines. The solid curve M–O depicts the relationship between strategic control and costs of managerial opportunism. Because of the separation of ownership and control (Jensen & Meckling, 1976), strategic control by boards over managerial decisions is necessary to contain managers' opportunistic behavior (Baysinger & Hoskisson, 1990; Fama & Jensen, 1983; Hermalin & Weisbach, 1998). When strategic control is absent, the firm is likely to be at risk of high costs of managerial opportunism. As the level of strategic control increases, boards monitor managerial decisions more closely and thus are more able to prevent the implementation of strategic decisions that benefit managers at the expense of shareholders, reducing the costs of managerial opportunism. Although the costs of managerial opportunism continue to decline as boards further increase the level of strategic control, the rate of decline tends to slow down because managers become increasingly constrained in their ability to engage in opportunistic behavior due to their disminished discretion in strategic decision making (Shen & Cho, 2005).

The dashed curve S–O depicts the relationship between board strategic control and strategic opportunity costs. When boards exert no strategic control over managerial decisions, their firms are potentially able to fully capitalize on managers' professional expertise in the pursuit of strategic opportunities. When boards increase strategic control to a level that is still acceptable to managers, it is likely to result in a rather limited increase in strategic opportunity costs. This is because managers still enjoy a sufficient level of discretion in strategic decision making, and thus will not see the increase of strategic control by boards as a challenge or threat to their decision-making authority and autonomy. However, if boards continue to increase the level of strategic control to a point beyond managers' level of acceptance, it will not only give managers a more limited range of strategic options to choose from (i.e., limited latitude of actions) but also have a more significant negative impact on their motivation, the speed and quality of strategic decision making, and the implementation of chosen strategies, thus leading to an accelerated increase in strategic opportunity costs.

The dashed curve A–L depicts the relationship between strategic control and the aggregated loss in shareholder wealth, which is the sum of strategic opportunity costs and the costs of managerial opportunism. It shows that the aggregated loss first decreases when an increase of strategic control leads to a greater reduction in the costs of managerial opportunism than the increase in strategic opportunity costs. However, as we explained above, when strategic control continues to increase and eventually exceeds managers' level of acceptance, it will incur significant strategic opportunity costs. Meanwhile, its marginal effect on the containment of managerial opportunism diminishes. As a result, the aggregated loss will start to increase after reaching the lowest level at point E, where the sum of strategic opportunity costs and managerial opportunism costs is at the minimum. Although it is difficult to directly gauge the strategic opportunity costs incurred and the reduction in the costs of managerial opportunism, some recent studies show evidence of lower shareholder wealth associated with a high level of strategic control by boards (Garg, 2013; Guldiken & Darendeli, 2016; Hoskisson et al., 2009; Knapp et al., 2011), consistent with our arguments and prediction.

Proposition 2. Strategic control by boards over managerial decisions has a curvilinear relationship with the aggregated loss in shareholder wealth, such that the aggregated loss first decreases and then increases as the level of strategic control increases to a point beyond managers' level of acceptance.

MODERATING EFFECT OF ORGANIZATIONAL DISCRETION

We further propose that organizational discretion, the concept we introduced earlier to describe the range of strategic options presented by a firm's industry and organizational characteristics, moderates the impact of strategic control on strategic opportunity costs and the aggregated loss in shareholder wealth. Strategic control by boards over managerial decisions leads to strategic opportunity costs because it directly limits managers' latitude of actions and reduces the firms' ability to capitalize on managers' professional expertise in pursuit of emerging strategic opportunities. As we explained earlier, managers' latitude of actions is jointly determined by organizational discretion and strategic control by boards over managerial decisions, with organizational discretion setting the upper limit of managers' latitude of actions. Thus, the degree to which strategic control reduces managers' latitude of actions, and consequently incurs strategic opportunity costs, depends on the level of organizational discretion—the latitude of actions managers have in the absence of strategic control by boards.

Because high organizational discretion presents a firm and its managers with more strategic opportunities (Hambrick & Finkelstein, 1987; Finkelstein et al., 2009), we expect that boards' strategic control over managerial decisions has a stronger effect on strategic opportunity costs in firms with high organizational discretion than in firms with low organizational discretion. Firms with high organizational discretion generally operate in a more dynamic and complex environment and have a wide range of strategic options to choose from, making the role of managers highly important (Crossland & Hambrick, 2007, 2011; Quigley & Hambrick, 2014; Shen & Cho, 2005). When boards exert little strategic control over managerial decisions, managers can take full advantage of the high latitude of actions available in strategic decision making and implementation, and the firm can benefit fully from managers' professional expertise in pursuit of emerging strategic opportunities. When boards increase strategic control over managerial decisions, this can significantly reduce managers' latitude of actions from the maximum level indicated by high organizational discretion. With an increase in the level of boards' strategic control, managers' latitude of action is further constrained, making them less able to take full advantage of the high latitude of actions presented by their industry and organizational characteristics. This significant reduction in managers' latitude of actions will greatly hinder their firms' ability to benefit from managers' professional expertise in pursuit of strategic opportunities presented by high organizational discretion, resulting in a high level of strategic opportunity costs. In contrast, in firms with low organizational discretion, managers have limited latitude of actions. In this situation, strategic control by boards is unlikely to reduce managers' latitude of actions significantly because of the limited range of strategic options managers have even in the absence of strategic control by boards (Crossland & Hambrick, 2007, 2011; Finkelstein et al., 2009; Shen & Cho, 2005).

Consequently, it is unlikely to result in a high level of strategic opportunity costs as in firms with high organizational discretion.

Proposition 3. Organizational discretion positively moderates the impact of strategic control on strategic opportunity costs such that an increase of strategic control by boards over managerial decisions leads to greater strategic opportunity costs in firms with high organizational discretion than in firms with low organizational discretion.

Meanwhile, because our conception of organizational discretion is only concerned with managers' latitude of actions but not their latitude of objectives, we do not expect it to significantly moderate the relationship between strategic control and the costs of managerial opportunism. The costs of managerial opportunism arise from managers' pursuit of private interests at the expense of shareholders, which can occur at any firm that provides managers with latitude of objectives (Shen & Cho, 2005), regardless of the level of organizational discretion. Like managers of firms with high organizational discretion, managers of firms with low organizational discretion can also engage in activities that serve their private interests at the expense of shareholders, such as private consumption of corporate resources in the form of perquisites (Boivie et al., 2011; Yermack, 2006), earnings management (Xie, 2001), unjustified sales of corporate assets to related parties (Lang et al., 1995), over-investments in empire building (Amihud & Lev, 1981; Stulz, 1990), and inappropriate bonus pool allocation (Bailey, Hecht, & Towry, 2011). Thus, although high organizational discretion may present greater potential for managerial opportunism, strategic control over managerial decisions is important to containing the costs of managerial opportunism in both firms with high organizational discretion and firms with low organizational discretion. In other words, we expect strategic control to have a similar effect on reducing the costs of managerial opportunism in both firms with high organizational discretion and firms with low organizational discretion. Given that the aggregated loss in shareholder wealth is the sum of the costs of managerial opportunism and strategic opportunity costs, the above arguments, together with the arguments leading to Proposition 3, suggest that strategic control is likely to have a stronger effect on the aggregated loss in shareholder wealth in firms with high organizational discretion than in firms with low organizational discretion.

Proposition 4. Organizational discretion positively moderates the impact of strategic control on the aggregated loss in shareholder wealth such that the curvilinear relationship between strategic control and the aggregated loss in shareholder wealth is stronger in firms with high organizational discretion than in firms with low organizational discretion.

To better illustrate the above proposed moderating effects of organizational discretion, Figure 2a and 2b depict the impacts of strategic control on strategic opportunity costs, the costs of managerial opportunism, and the aggregated loss in shareholder wealth in firms with high versus low organizational discretion, respectively. As shown, the dashed curve S–O increases at a greater rate in Figure 2a than in Figure 2b, illustrating the positive moderating effect of organizational discretion on the relationship between strategic control and strategic opportunity costs suggested in Proposition 4. In contrast, the solid curve M–O decreases at about the same rate in Figure 2a and Figure 2b, illustrating that organizational discretion does not significantly moderate the relationship between strategic control and the reduction in costs of managerial opportunism. As a result, the dashed curve A–L reaches the inflection point E faster at a lower level of strategic control and then increases at a greater rate in Figure 2a than in Figure 2b, illustrating the positive moderating effect of organizational discretion on the relationship between strategic control and the aggregated loss in shareholder wealth suggested in Proposition 4.

Insert Figure 2a & 2b about here

ORGANIZATIONAL DISCRETION, BOARD CONTROL, AND FIRM PERFORMANCE

Because strategic control over managerial decisions can lead to trade-offs between the containment of managerial opportunism and incurrence of strategic opportunity costs, particularly in contexts of high organizational discretion, boards are likely to choose carefully between strategic control over managerial decisions and financial control of managerial incentives as the primary internal governance mechanism based on the level of organizational discretion. In firms with high organizational discretion, we expect that boards are likely to rely more on financial control of managerial incentives as the primary internal governance mechanism. Although strategic control over managerial decisions can help contain managerial opportunism, our arguments above suggest that a high level of strategic control can lead to significant strategic opportunity costs and an increase in the aggregated loss in shareholder wealth in firms with high organizational discretion. Thus, boards of these firms are likely to limit the level of strategic control to avoid incurring significant strategic opportunity costs and aggregated loss in shareholder wealth. Instead, they are likely to focus more on the alignment of managers' interests with those of shareholders, and to rely more on financial control of managerial incentives as the primary internal governance mechanism.

Such an arrangement in internal governance enables firms to reduce the costs of managerial opportunism while capitalizing on managers' professional expertise in the pursuit of strategic opportunities. High organizational discretion presents firms with many strategic opportunities (Hambrick & Finkelstein, 1987). To capture these opportunities, it is critical to align managers' interests with those of shareholders so that managers can fully utilize their professional expertise to bring about outcomes desired both by them and by their shareholders. Unlike strategic control, financial control attempts to align managers' interests with those of shareholders through performance-based incentives while leaving managers with decision-making authority and autonomy (Baysinger & Hoskisson, 1990; Eisenhardt, 1989a). As a result, it is designed to limit managers' latitude of objectives without reducing their latitude of actions (Shen & Cho, 2005).

Given that high organizational discretion provides a wide range of strategic options to choose from (Crossland & Hambrick, 2007, 2011; Quigley & Hambrick, 2014), managers are likely to welcome boards' reliance on financial control in corporate governance because it gives them control over the strategic actions they can undertake in the pursuit of strategic opportunities and their own rewards. This sense of control will motivate managers to work hard in the process (Bandura, 2006; Thomas & Velthouse, 1990). In addition, reliance on financial control makes managers more likely to seek strategic advice and help from boards so that they can benefit from directors' human and social capital (Westphal, 1999). Thus, we propose that firms with high organizational discretion are likely to rely more on financial control in internal corporate governance, and doing so is likely to result in higher firm performance than relying more on strategic control would do.

Proposition 5a. Firms with high organizational discretion are likely to rely more on financial control than strategic control in internal corporate governance.

Proposition 5b. Under high organizational discretion, firms relying more on financial control in internal corporate governance are likely to have higher performance than firms relying more on strategic control in internal corporate governance.

In firms with low organizational discretion, boards are likely to rely more on strategic control rather than financial control as the primary internal corporate governance mechanism. Because low organizational discretion presents firms with limited strategic options to choose from, managers are constrained in their ability to influence firm performance (Hambrick & Finkelstein, 1987; Shen & Cho, 2005). In this context, the use of performance-based incentives emphasized by financial control is unlikely to be effective in motivating managers or promoting firm performance for the following two reasons. First, because managers are constrained in their ability to influence firm performance (Crossland & Hambrick, 2007, 2011; Quigley & Hambrick, 2014), they will not have a strong sense of control over the outcomes and thus are less likely to be motivated by performance-based incentives (Bandura, 2006; Thomas & Velthouse, 1990). Second, even if performance-based incentives are to some degree effective in motivating managers to work hard, they are likely to have a very limited impact on firm performance because the link between managerial efforts and firm performance is weak when managers have a low latitude of actions (Shen & Cho, 2005). Thus, firms with low organizational discretion are likely to rely less on financial control as the primary internal corporate governance mechanism.

Instead, they are likely to rely more on strategic control in internal corporate governance. As we explained earlier, increase in strategic control does not lead to a significant increase in strategic opportunity costs when organizational discretion is low. Thus, boards are likely to be less concerned with the strategic opportunity costs incurred by strategic control. Meanwhile, although firms with low organizational discretion have limited strategic opportunities, they can still be at a high risk of managerial opportunism because managers can still abuse their power by engaging in activities that benefit their private interests at the expense of shareholders (Shen & Cho, 2005). In this context, boards are likely to be more concerned with the containment of managerial opportunism than the pursuit of limited strategic opportunities. Moreover, because the strategic choices of these firms are less complex and less time sensitive, boards tend to possess sufficient information and expertise to engage in strategic control. Thus, by closely monitoring managerial decisions and actions, boards can be more effective in containing managerial opportunism than relying on performance-based incentives. Taken together, the above arguments lead to the following propositions:

Proposition 6a. Firms with low organizational discretion are likely to rely more on strategic control than financial control in internal corporate governance.

Proposition 6b. Under low organizational discretion, firms relying more on strategic control in internal corporate governance are likely to have higher performance than firms relying more on financial control in internal corporate governance.

DISCUSSION AND CONCLUSIONS

Our main purpose in this paper is to contribute to the understanding of how strategic control by boards over managerial decisions influences shareholder wealth by drawing attention to the strategic opportunity costs it incurs, particularly in contexts of high organizational discretion. While previous research has primarily focused on the benefits of strategic control by boards in containing managerial opportunism (Baysinger & Hoskisson, 1990; Dalton et al., 2007; Fama & Jensen, 1983; Hermalin & Weisbach, 1998; Walsh & Seward, 1990), our paper highlights that it also reduces managers' latitude of actions in the pursuit of strategic opportunities and thus incurs strategic opportunity costs due to its adverse effects on managerial motivation, the speed of strategic decision making, the quality of communication between managers and directors, and the implementation of chosen strategies. Taken together, we argue that strategic control leads to trade-offs between the containment of managerial opportunism and the pursuit of strategic opportunities, and will result in losses rather than gains in shareholder wealth when the strategic opportunity costs incurred are greater than the reduction in costs of managerial opportunism.

We then develop a contingency perspective about the relationship between strategic control by boards over managerial decisions and shareholder wealth by attending to the moderating effect of organizational discretion, a new concept we introduce to describe managers' latitude of actions presented by industry and organizational characteristics in the absence of strategic control by boards. Specifically, we propose that the trade-offs of strategic control by boards over managerial decisions are more pronounced in firms with high organizational discretion than in firms with low organizational discretion, and consequently influence boards' reliance on strategic control versus financial control in internal corporate governance. We propose that boards in firms with high organizational discretion are likely to rely more on financial control, whereas boards in firms with low organizational discretion are likely to rely more on strategic control as the primary internal corporate governance mechanism. Moreover, we contend that firms whose internal corporate governance mechanism is aligned with their level of organizational discretion tend to have higher performance than firms whose internal corporate governance mechanism is not aligned with their level of organizational discretion.

Our paper makes several contributions. First, it provides a more complete view about how strategic control by boards over managerial decisions influences shareholder wealth. Previous research on corporate governance has primarily focused on the benefits of strategic control by boards in the reduction of agency costs associated with managerial opportunism (Adams et al., 2010; Dalton et al., 2007). In contrast, our paper cautions that increased strategic control by boards over managerial decisions can lead to losses in shareholder wealth because it limits managers' latitude of actions and incurs strategic opportunity costs. As corporate governance scholars and practitioners increasingly emphasize board control over managerial decisions in the protection of shareholder interests, it is important to recognize the trade-offs involved, particularly regarding how strategic control by the board may compromise a firm's ability to capitalize on managers' professional expertise in the pursuit of strategic opportunities—one of the main advantages that arise from the separation of firm ownership and control.

Second, our paper contributes to the growing body of research on managerial discretion by introducing the concept of organizational discretion and using it to bridge the strategy and governance perspectives of managerial discretion that have evolved separately in the literature (Shen & Cho, 2005; Ponomareva and Umans, 2015). Because managers with high latitude of actions have a greater impact on firm performance (Crossland & Hambrick, 2007, 2011; Hambrick & Finkelstein, 1987; Quigley & Hambrick, 2014), and strategic control by boards can limit managers' latitude of actions (Finkelstein et al., 2009; Shen & Cho, 2005), it is important to distinguish managers' latitude of actions in the absence of board control from their latitude of actions in the presence of board control. This distinction will better enable scholars and practitioners to develop a more comprehensive understanding of how strategic control by boards over managerial decisions can influence firm performance. The concept of organizational discretion serves such a purpose as it describes managers' latitude of actions presented by their industry and organizational characteristics in the absence of board control. Our theory and propositions suggest that organizational discretion not only moderates the impact of strategic control on strategic opportunity costs and the aggregated loss in shareholder wealth, but also influences boards' choice between strategic control and financial control as the primary internal corporate governance mechanism. We look forward to future research distinguishing between organizational discretion and managers' latitude of actions in investigations to enhance the understanding of how organizational discretion and board control jointly influence managers' latitude of actions and firm performance.

Our study also contributes to the understanding of the choice between strategic control and financial control in internal corporate governance. Organization scholars have primarily treated strategic control over managerial decisions and financial control of managerial incentives as either complementary or substitutable internal corporate governance mechanisms in the investigation of their effects on firm performance (Ward, Brown, & Rodriguez, 2009), with little consideration of the contextual factors that may affect a firm's choice between them. By paying attention to the strategic opportunity costs incurred by strategic control and the moderating effect of organizational discretion, our paper suggests that a firm's organizational discretion influences the board's choice of whether to rely more on strategic control or financial control in internal corporate governance. This idea of alignment between a firm's internal corporate governance mechanism and its organizational discretion is consistent with the contingency perspective of strategic fit (Venkatraman, 1989), and has important implications for research on the performance effect of corporate governance. Specifically, it provides a potential explanation for the inconsistent empirical results about the effects of internal corporate governance mechanisms on firm performance (Boivie et al., 2016; Dalton et al., 2007; Li, Terjesen, & Umans, 2018), and calls for scholars to pay attention to the moderating effect of organizational discretion in future investigations.

Lastly, our paper has important practical implications for corporate governance and board involvement in strategic decision-making. First, our theory and propositions suggest that boards need to consider the trade-offs between the reduction in managerial opportunism costs and the incurrence of strategic opportunity costs in determining the degree to which they should exert strategic control over managerial decisions. Second, when boards decide to become more involved in strategic decision-making because of the expertise possessed by individual directors or the presence of strategists on the boards (McNulty & Pettigrew, 1999; Ravasi & Zattoni, 2006), they shall proceed with care to avoid seriously challenging or threating managers' decision-making authority or autonomy. Our theory and propositions suggest that board involvement in strategic decision-making is likely to have a more positive effect on firm performance when it helps to enhance (i.e., helps to generate more strategic options) rather than limit managers' latitude of actions. Third, boards need to consider the level of organizational discretion presented by their firms' industry and organizational characteristics in determining the design and implementation of internal corporate governance mechanism. For example, they should rely more on financial control of managerial incentives as the primary internal governance mechanism to align the interests of managers and shareholders in contexts of high organizational discretion, while avoiding using a high level of strategic control over managerial decisions because of the significant strategic opportunity costs this would incur. On the other hand, because the implementation of financial control in firms with low organizational discretion is unlikely to result in significant improvement in firm performance, boards of these firms should focus more on the containment of managerial opportunism and rely more on strategic control in internal corporate governance.

Although we believe that our theory about the trade-offs incurred by boards' strategic control over managerial decisions is universally applicable, this paper is primarily concerned with the ongoing practices in countries such as the U.S. that have adopted policies intended to significantly reduce managers' decision-making authority and autonomy (Adams et al, 2010; Finkelstein et al., 2009). According to our theory, these practices can lead to significant strategic opportunity costs and aggregated loss in shareholder wealth. It is worth noting that boards do not all exert strong control in corporate governance; instead, they are still rather weak in countries such as China (Shen, Zhou, & Lau, 2016). In this situation, an increase of strategic control by boards over managerial decision is likely to reduce the aggregated loss in shareholder wealth because the reduction in the costs of managerial opportunism tends to be greater than the strategic opportunity costs incurred.

A natural next step is to empirically test our theoretical predictions, particularly those regarding the relationships between organizational discretion, board control, and firm performance (e.g., P5a, P5b, P6a, & P6b). Although it is difficult to directly measure strategic opportunity costs, the costs of managerial opportunism, and the aggregated loss in shareholder wealth, there are several potential directions researchers can undertake in empirical investigations. One is to use firms' market value as a proxy for shareholder wealth and investigate its relationship with strategic control, based on the assumption that a firm's market value incorporates investors' assessments of how strategic control influences the aggregated loss in shareholder wealth due to the trade-offs between strategic opportunity costs and the costs of managerial opportunism. Another direction is to use economic value created (EVC) as a proxy for the firm's ability to capitalize on managers' expertise in the pursuit of strategic opportunities, and investigate its relationships with strategic control and financial control under different levels of organizational discretion. Organizational discretion can be measured using the industry and organizational characteristics that have been well established as factors that influence managers' latitude of actions (Berman, Phillips, & Wicks, 2005; Finkelstein et al., 2009; Hambrick & Abrahamson, 1995). With respect to the measurement of strategic control and financial control, prior research has suggested and validated several measures using both observable indicators and surveys of CEOs and directors (Baysinger & Hoskisson, 1990; Boyd, 1994; Westphal, 1999).

Another potential venue for future research is to investigate how boards choose the performance targets for managers in the design and implementation of financial control of managerial incentives. Although we suggest that financial control limits managers' latitude of objectives through incentive alignments without limiting their latitude of actions to bring about the performance outcomes demanded by boards, it does not mean that there are no trade-offs involved in financial control. For example, in deciding the performance targets for managers to bring about, boards need to choose from a set of potential outcomes that may have different implications for managers in strategic decision-making, such as profits versus growth or short-term performance versus long-term performance (Devers, Cannella, Reilly, & Yoder, 2007; Sanders & Hambrick, 2007). These trade-offs are different from the trade-offs we focus in this article between the containment of managerial opportunism and the pursuit of strategic opportunities. However, we consider it a natural extension of our theory to investigate how boards choose the performance targets in the use of financial control because such studies can greatly enhance the understanding of how boards design and implement financial control, particularly in contexts of high organizational discretion, to minimize strategic opportunity costs.

ENDNOTES

1. It is important to note that managers' personal characteristics, such as aspiration level and cognition complexity, influence their perceptions of latitude of actions as well (Hambrick & Finkelstein, 1987). To reduce the complexity of our theoretical model, we focus on the objective industry and organizational characteristics in our conception of organizational discretion, and assume managers to be of similar capability in exploring the strategic options presented by these objective characteristics.
2. Our discussion here focuses only on the increase of strategic control by boards over managerial decisions because such a change directly reduces managers' latitude of actions in making and implementing strategic decisions. When boards increase financial control of managerial incentives, although such a change limits managers' latitude of objectives through interest alignment, it does not directly reduce managers' latitude of actions as it still gives managers decision-making authority and autonomy in choosing from the range of strategic options to bring about the performance outcomes demanded by boards (Shen & Cho, 2005).

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