Board directors are supposed to have broad knowledge, but are they also narrow experts?

We all know about the experts who know so much about so little, and so little about so much. Scientists and artists are prime examples of specialised occupations whose members are suspected of being impractical in daily life.

Managers, on the other hand, are supposed to have broad and practical knowledge, and to be flexible in what they do. These are stereotypes, of course, so they are a mix of truth and falsehood. A good way to understand the mix is to look at the central governance of firms – the board of directors – which is supposed to represent all stockholders and to help the firm through their wide knowledge. Directors are supposed to have even broader knowledge than managers. But are they also narrow experts?

Our recent paper looked at this question using data on how Chinese firms made acquisitions during the market reform that started in the 1980s and accelerated in the 1990s. This was the time when the state was strongly encouraging all firms, state-owned or private, to become efficient, market oriented, and profitable, to grow the Chinese economy. Acquisitions were a frequently used tool to accomplish that because many firms had problems that could be solved through combining them.

It was a great opportunity for market-oriented firms to acquire less efficient firms and improve their operations. In many cases, improving operations also meant that they needed fewer workers and would fire many of them, contrary to what they did before the market reform, when they would try to maintain employment even if it led to lower performance.

But there was also one more form of acquisition. The state (local or central) sometimes played matchmaker between firms in order to rescue weaker firms. These rescues did not mean to make them more profitable. They were meant to avoid the search for efficiency gains that could leave workers unemployed.

Firms reacted differently to the different acquisition opportunities they had, because they could ignore the state's matchmaking and pursue market acquisitions, like a free-market firm. Or, they could agree to the matchmaking and avoid market acquisitions, like a state-owned firm. These decisions were made by the board of directors, who are supposed to do what's best for the firm, regardless of the director's background.

That's not what happened. Director background decides the director experience, and the director experience decides what the director wants to do and is good at doing.

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Firms had directors with both market economy and state experience in different proportions. Our research showed that the directors ended up splitting the board into coalitions battling to make the type of acquisition that best matched their experience, so when a firm had many directors with state experience the firm ended up making more of the state's matchmaking acquisitions.

Ironically, that was against the current state policy of market reform, so it meant that directors were following their experience, not state instructions. Boards with directors who had more market-economy experience made more market acquisitions, even if the firms were state owned. These directors were among the leaders in implementing the market reform.

Did it matter who owned the firm? Yes it did, and in the way you would expect. More state ownership made the firm more likely to agree to state matchmaking. But ownership and board membership worked differently in these firms.

Less state ownership made firms less likely to agree to matchmaking no matter what. When the firm had fewer board members with state experience it was more responsive to performance when deciding their acquisition strategy. This is what we should expect, because a director with market experience sees acquisitions as ways to solve problems and pursue opportunities. For a director with state experience, acquisitions are simply risky things to do unless they are the result of state matchmaking. These are different ways of thinking about a very important strategic action, and they come from the ways that experience shapes thinking.

Experience gives expertise but also blinders. When the experience of directors influences their actions strongly, the result is often politics to create a winning coalition. This means that the board of directors is important in more ways than we thought before, because a director with narrow and deep experience may end up as an advocate of following that experience, even if it does not fit the needs of the firm. Owners beware.

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Notes:

- *This blog post is based on the authors' paper [Dominant Coalitions Directing Acquisitions: Different Decision Makers, Different Decisions](), Academy of Management Journal, 2018, forthcoming.*
- *The post gives the views of its author, not the position of LSE Business Review or the London School of Economics.*
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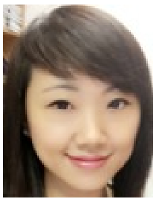

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