



Who Drives Unrelated Diversification? A Study of Indian Manufacturing Firms

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Abstract. This paper builds on recent research that focuses on the context-specific nature of diversification and the impact of organizational ownership on the choice of diversification strategy. Set in the Indian manufacturing sector, it compares the influence of institutional investors and banks against the influence of CEOs and boards on unrelated diversification. Results show that (a) external constituents collectively have more influence on unrelated diversification than CEOs and boards, (b) institutional investors tend to discourage unrelated diversification, but banks are quite supportive of such moves, and (c) corporate governance constituents other than foreign directors do not have a statistically significant influence on unrelated diversification strategies.

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Corporate diversification is a central focus of academic and practitioner interest within the domain of strategic management (Ansoff, 1965; Chandler, 1962; Goold, Campbell and Alexander, 1994; Palich, Cardinal and Miller, 2000; Rumelt, Schendel and Teece, 1994). This stream of inquiry has strong multi-disciplinary roots, attracting the research interests of scholars from fields such as accounting, economics, finance, management and sociology.

Within the realm of research on corporate diversification, much attention has always focused on the pros and cons of *related v. unrelated diversification*. Although a better picture of the advantages and pitfalls of *related diversification* has emerged as a consequence (see Palich, Cardinal and Miller, 2000), a similar fine-grained understanding of unrelated diversification has proven to be elusive (Campbell, Goold and Alexander, 1995; Goold and Luchs, 1993; Khanna and Palepu, 1997; Lane, Cannella and Lubatkin, 1998). However, some of the pieces of the puzzle are starting to fall into place. Two particularly interesting developments of recent vintage relate to the context within which diversification occurs, and the nature of the ownership of the firm that is diversifying.

Adopting a macroeconomic perspective, Khanna and Palepu (1997) argued that unrelated diversification strategies may be particularly relevant in emerging market contexts. Since many of these settings exhibit significant dimensions of market failure spanning capital, labor, and product markets, the authors suggested an attempt to bridge such failures through diversification may indeed be profitable. Although intuitively appealing, many of the recent empirical examinations that have studied the performance impact of diversification in emerging markets have reported mixed results. Even though the evidence is hardly unequivocal, the conceptualization of diversification as a response to market failures appears to be an interesting one worthy of further exploration. At a minimum, it seems to underscore the possibility that performance outcomes related to diversification may be country specific.

Employing a more manager-focused perspective, financial economists and strategic management researchers have been engaged in a debate over the specific actors who are responsible for propelling the firm to pursue unrelated diversification strategies. While the financial economists cast organizational managers as self interested individuals who diversify to protect their own income flow and stem employment risks (Fama, 1980; Fama and Jensen, 1983), strategic management researchers view managers as responsible decision makers driven by the desire to improve organization-wide gains as opposed to private riches (Davis, Schoorman and Donaldson, 1997). Exploring this debate further may throw light on the specific constituents who are likely to have a significant impact on corporate diversification decisions.

Given the often insurmountable data constraints, many of the researchers who have examined the environmental context within which diversification takes place have had to limit their focus to a few of the developed economies such as the U.S., the U.K., and Germany. It would now be valuable to extend this line of research to explore emerging market contexts both to understand whether the findings generated in developed country settings are transferable, and to gain further insights into the manner in which the typical corporate governance mechanics and constituents play their roles as guardians of firm value in such markets.

Unlike the U.S., many developing countries are characterized by a web of family-owned and family-controlled corporations, less stringent board governance mechanisms, and a significantly higher proportion of government holdings even in the private sector (Easterby-Smith, Malina and Lu, 1995; Heuze-Brigant, 1996; Negandhi, 1973; Whitley, 1990, 1992). It is quite likely that stakeholder influence in directing corporate strategy will be tempered by these unique corporate governance arrangements and contextual features. Since these characteristics normally do not have close parallels in the U.S. or other developed economies, by studying developing country contexts, it would be possible to examine the role of factors such as institutional systems, capital market conditions, and the spread of family controlled conglomerates on corporate strategy. These studies could then form the building blocks in developing a better understanding of diversification strategies and practices worldwide.

Who are the organizational actors who initiate the process of unrelated diversification? What vested interests do organization leaders have in promoting unrelated diversification strategies? How do boards and shareholder activists view unrelated diversification? How do they influence the choice of such strategies? What role does country context play in determining the specific roles of stakeholders in defining corporate strategy? These are but a few of the critical questions that have become the focus of recent research attention.

In keeping with the objective of filling prevailing knowledge gaps, this paper integrates prior literature across various sub-streams such as strategic leadership, corporate governance and financial economics to examine the roles of individual shareholder groups and corporate governance mechanisms in driving unrelated diversification strategies. Set within the Indian context, it specifically focuses on the role and motivations of disparate shareholder groups and how they are likely to influence corporate choices. This measure of influence is evaluated against the potential power held by CEOs and boards to explore the relative levels of influence that the internal and external constituents exert.

In recent years, increasing attention has focused on the performance outcomes of diversification in emerging markets. Much of the recent work in this stream can be traced to Khanna and Palepu (1997) who argued that diversification as a response to market failure in emerging contexts can indeed be profitable. They reasoned that the absence of adequate infrastructure both institutional and physical forces firms to internalize many of the functions that are normally performed by an external market such as distribution, provision of skilled labor resources, and capital market access. Although this line of reasoning did seem to explain the rise of conglomerates throughout the developing world and also the historic dominance of such organizational form in the developed countries of yesteryears, the empirical evidence thus far has been muddy at best.

Unfortunately many of the empirical studies have not made a clear distinction between related and unrelated diversification for the most part. A large number of them have used a dummy variable coded to indicate whether or not a firm derived a majority of its revenues from a single two-digit SIC code (>90%). Thus, any firm that is not a dominant business (Rumelt, 1974) is automatically categorized as a diversified firm hence leaving untapped the related v. unrelated dimension. The precious little by way of evidence in support of the beneficial effects of diversification is far from clear. For example Khanna and Palepu (2000a, 2000b) found that there is a curvilinear relationship between *group* diversification and performance suggesting that there is a threshold limit or point of inflection until which diversification has a negative performance effect. The threshold has to be exceeded for diversification to be beneficial. In contrast, Chibber and Majumdar (1999) and Sarkar and Sarkar (2000) reported that there was no evidence of a statistically significant relationship between diversification and performance in India. Mitton's (2002) study of five emerging markets and Fauver, Houston and Naranjo's (2003) study of a sample of emerging markets both showed that the relationship between diversification and performance was indeed negative. Others such as Claessens et al. (2003) and Lins and Servaes (2002) reported the presence of a negative relationship between diversification and performance when their models explicitly factored in the group affiliation aspect. The cumulative evidence consequently does not offer a consensus view on the form of the relationship in emerging markets, the persuasive theoretical arguments notwithstanding.

1. The choice of unrelated diversification: Who is responsible?

A substantial stream of research on the motives and outcomes of diversification strategies has centered on the roles played by external organizational players such as block shareholders

(Brickley, Lease and Smith, 1988; Denis, Denis and Sarin, 1997; Lane, Cannella and Lubatkin, 1998) and internal organizational mechanisms of corporate governance including the role of CEOs and top management teams (Davis, Schoorman and Donaldson, 1997; Lane, Cannella and Lubatkin, 1998), and the board of directors.¹ Much of the contemporary research has framed the motivations for choosing diversification strategies within the perspective of management v. shareholders originating in the tenets of agency theory. Thus, there have been some studies which have suggested that external corporate governance constituents such as block shareholders are likely to deter unrelated diversification (Brickley, Lease and Smith, 1988; Denis, Denis and Sarin, 1997) while others report that internal governance constituents such as the CEO, top management teams, motivated by private gains and self interest, are prone to pursue unrelated diversification strategies (Aggarwal and Samwick, 2003; Amihud and Lev, 1981).

It is important to emphasize that these findings largely originate in developed country settings where the incidence of market failures, although possible, are limited.² In developed country settings, where such failures are less prevalent, one could argue (based on Khanna and Palepu, 1997) that there would be no justifiable motive to pursue unrelated diversification strategies and that the pursuit of such strategies may indeed lead to erosion of firm value, generating private gains primarily. Further, the key external constituents are the shareholders at large who are believed to have a vested interest in ensuring that the management of the company adopts strategies that help increase firm value. While the focus on firm value might indeed cut across all types of shareholders, it is plausible that their emphasis on growth and value objectives could vary from one group to another. For example, banks which might hold equity in their customer companies might be more indulgent of top management when it comes to decisions of corporate strategy. The average institutional investor or mutual fund may not necessarily adopt the same stance. Despite these differences across shareholder types, most of the studies that have examined these external constituents have tended to paint them with the same brush.

We argue that the role of the various organizational owners changes with the specific features of the context within which they operate. For example, the banks in developed countries such as the U.S. and the U.K. play a lesser role as conduits of debt capital to for-profit business than their counterparts in countries like Indonesia, India and Thailand. Individual investors in some of these countries may have fewer investment options than their counterparts in developed country settings given the inherent inadequacies of the capital market and the compounding ill effects of regulation. Taken together, we suggest that not only are different owners predisposed to different types of behavior but also that the nature of these behaviors will be strongly influenced by the context. We use this framework to explore the unique context-bound influences that both external and internal governance constituents exert on corporate strategy choices in general and unrelated diversification strategies in particular. Given the variation in the contextual dimensions of emerging market economies, our objective is to develop broad insights before distilling universal tenets that could be applied across a range of emerging markets. Therefore, we use the specific case of India in developing and evaluating the core propositions.

1.1. *The external influences on diversification strategy*

Organizational owners have been the focus of study for a lot of interrelated streams of research spanning financial economics, organizational theory, and strategic management. Much of this line of research has examined the influence that the owners of an organization exert in terms of monitoring firm performance or strategic actions initiated by management. The landmark study by Amihud and Lev (1981) reported that organizations where large block shareholders were absent tended to be more involved in unrelated acquisitions and had higher levels of diversification than firms where large block shareholders were present. More recently, May (1995) reported findings that showed a negative relationship between a proxy for a manager's investment in a firm and the covariability of target and bidder returns, implying that managers with large amounts of investments in their firms tended to reduce their employment and personal investment risk through diversifying acquisitions. Along similar lines, Denis, Denis and Sarin (1997) reported that the level of diversification was negatively related to managerial equity ownership and that diversification level decreased when external corporate control threats were present. Thus, while there is some accumulating evidence that external owners (shareholders) do indeed have a role to play in directing the nature of strategies pursued by the firms in which they hold equity interest, a fine-grained understanding of the specific nature and direction of such influence has not yet emerged.

One of the key reasons that underlie the dearth of fine-grained insights into ownership behavior is probably the standard empirical approach that tends to paint all owners with the same brush. It assumes that *all* shareholders have the *very same* monitoring and performance motives, an assumption that is questionable in light of recent evidence. Some studies of late have suggested that different ownership groups tend to have different objectives and expectations and behave differently (Brickley, Lease and Smith, 1988; David, Kochhar and Levitas, 1998). Not all owners are alike. They can be distinctly different from one another based on the specific expectations that they bring and the extent of active monitoring that they perform (Monks and Minow, 1995; O'Barr, Conley and Brancato, 1992). Thus, while some owners might draw upon their powers only when they have sizable equity holdings, others might not be as patient and engage in active monitoring at much lower levels of ownership (Brickley, Lease and Smith, 1988; David, Kochhar and Levitas, 1998).

Brickley, Lease and Smith (1988) proposed a three-part classification of owners based on the nature of relationship that they have with the organizations they invest in. The *pressure-sensitive* owners are those that are susceptible to the influence exercised by the firm's managers. *Pressure-resistant* owners are characterized as pure investors who have clear profit and growth objectives that cannot be influenced by an organization's managers. The *pressure-indeterminate* group does not have a clearly defined relationship with the firm's managers, playing a passive role in some situations and a marginally active role in others. Of particular interest in the emerging market context are the pressure-resistant and pressure-sensitive groups of investors.

1.1.1. *Pressure-resistant investors: Institutional investors and mutual funds.* Drawing on the classification proposed by Brickley, Lease and Smith (1988), institutional investors can be termed "pressure-resistant" since they owe no allegiance to the firms in which they

invest. They typically exhibit an aggressive stance toward building shareholder value and demand positive actions from the company in keeping with those objectives. Should company management fail to deliver, these investors often move their investments elsewhere and thus hold substantial clout in the corporate governance process of the firm. Consequently, these block shareholders are expected to exercise influence over the nature of diversification strategy that the firm's managers may choose to adopt. These shareholders will be vigilant in guarding against opportunistic managerial behavior that could result in wealth destroying activities. Although there may be more than one institutional investor, and their individual holdings might be small, as a group they are known to gain power through coordinated actions (David, Kochhar and Levitas, 1998). Hence, it has been suggested that their behavioral dispositions may be more similar than dissimilar as a group (Useem, 1996; Wahal, 1996). Since they do not have any business relationships with the firms that they invest in, they are more likely to exercise their fiduciary responsibility and actively counsel organizational management against wealth destroying moves. In essence, they can be expected to bring with them an aggressive monitoring approach that limits managerial excesses and exploitation of self-interests to the detriment of shareholders.

It can be argued that the nature of the influence and monitoring exercised by this group of investors is largely context free. The developing v. developed country dichotomy is not germane to the aspirations of this ownership group in general. First, even in many of the developing countries such as India, many of the mutual funds companies are operated in full or in part by multinationals such as Franklin Templeton, HSBC, Morgan Stanley, Prudential and Standard Chartered among others. This necessitates that even the domestic institutional investors embrace a different set of competitive standards to ensure continued success. Given the mobility of capital, many of the fund managers have the option of choosing across a wide variety of investment opportunities in multiple geographies. Therefore, they may be less willing to make substantial concessions in their expectations and put up with lesser transparency, a hallmark of business groups (Khanna and Palepu, 1997), when they can easily move their funds to other locales where their returns are not subject to context-specific vagaries. Perhaps in the pre-1991 era of capital market control there might have been tangible benefits to be gained by the institutional investors who patronized diversified conglomerates. These market failures have slowly started to give way to higher levels of efficiency and hence the institutional investors may not see the traditional emerging market tradeoffs between transparency and returns as meaningful.

Further, in light of debatable evidence linking unrelated diversification and performance, these investors may choose to focus on firms that stick to their knitting. In sum, institutional investors and mutual fund investors may not be attracted to investment opportunities in diversified business houses because (a) transparency is low given the web of crossholdings with other group firms, (b) most of the large diversified business groups are widely held firms raising free rider problems should the institutions invest time and resources in monitoring the strategies and outcomes, and (c) changes in the marketplace following economic reform present alternative investment options that were hitherto absent.³

1.1.2. Pressure-sensitive investors: Banks and banking companies. Banks and banking companies are classified as "pressure-sensitive" investors (Brickley, Lease and Smith, 1988).

They are often involved in important business relationships with the companies in which they invest. They are in a sense dependent on these firms for a large part of their income because they either derive interest income from the loans they offer these corporations or obtain fee income by meeting the financial needs of the firms in which they invest. This dependence places them in a delicate position when it comes to active monitoring and control of firm management. Therefore, despite their equity position, they are likely to be reluctant in counseling management against specific corporate strategy moves that could prove detrimental to shareholder's interests. It is quite likely that this symbiotic relationship will be accentuated in settings where the banking system is responsible for a large proportion of the capital stock of organizations, e.g., developing countries, and where there are few credible large borrowers who can promise growth and low default rates. Thus, it is in the interest of the banks and banking companies in these contexts to maintain equilibrium in their relationships with the borrowers to ensure a steady inflow of fee-based income. Hence, these shareholders aid the firm's management in pursuing unrelated diversification strategies should company management so desire.

With the advent of foreign competition in banking and the emergence of other capital market alternatives, banks are forced to trade on their strong bonds with the corporate houses to shore up their fee income. Further, since much of the merger and acquisition activity is financed through debt, banks stand to gain considerably by continuing to embrace management's desire to diversify even into unrelated sectors.⁴ The profitability of their relationship could indeed hinge on the number and size of the deals they are able to cobble together rather than the individual profitability of each investment. Fee income can exceed the returns that the investments yield in the long term. Thus, in preserving their steady stream of income, these investors are reluctant to rock the boat and hence continue to enjoy the patronage of corporate houses. The relationship could be viewed as quite symbiotic.

1.2. The internal influences on diversification strategy

The CEO and the top management team are believed to shape strategic directions since they are vested with the responsibility of designing and implementing strategies that help navigate the organization through the variety of environmental constraints that often arise (Finkelstein and Hambrick, 1996; Geletkanycz and Black, 2001; Geletkanycz and Hambrick, 1997). The directors on the board have oversight responsibility over such actions and have the ultimate power to either approve or disapprove the strategy choices presented by the CEO and the top management and also to monitor the performance of the organizational leaders (Gedajlovic and Shapiro, 1998; Williamson, 1975, 1981). The shareholders at large are the "owners" and hence have a clear interest in ensuring that the strategy choices increase the overall value of the firm (Charkham and Simpson, 1999; Fama and Jensen, 1983; Monks and Minow, 1995). Although both internal and external constituents have legitimate reasons to influence the strategy making process, unraveling the relative influence of these groups could be a nettlesome issue as illustrated by the recent debates between financial economist and strategic management researchers.

Building on the tenets of agency theory (Fama and Jensen, 1983; Jensen and Meckling, 1976), financial economists (Amihud and Lev, 1981; Denis, Denis and Sarin, 1997) have

argued that managers (agents) will act to protect their own interests by using organizational diversification to reduce variability in their earnings, actions that often hurt shareholder (principals) interests. Blending strands of literature from perspectives within the realm of management theory such as stewardship, entrepreneurship and top management teams, strategic management researchers (see Lane, Cannella and Lubatkin, 1998 and 1999 for an exhaustive discussion of the competing positions) argue that *both* managers and shareholders are concerned about unsystematic risk, and that managers are good stewards who align themselves closely with organizational interests. Thus, they do not see any apparent conflict in objectives or an incentive for managers to act in their self-interest. Perhaps a finer understanding of the internal and external constituents would be a good first step toward developing insights into these sharp differences in perspective regarding the role of CEOs versus the roles of owners.

1.2.1. CEO power and corporate diversification. CEOs, according to agency theory, have very strong reasons to engage in some sort of diversification. Although much of agency theory and the subsequent work of the financial economists do not explicitly distinguish between the various types of diversification, it is quite clear that they indeed address value destroying diversification (i.e., unrelated diversification). CEOs are thought to promote unrelated diversification because (a) it reduces the variability of their earnings, (b) it increases the level of their compensation since the board sees them handling the complex task of running a company that is involved in multiple unrelated businesses, and (c) it reduces the risk of unemployment because they are assured of their centrality in orchestrating strategies in the multibusiness enterprise (see Aggarwal and Samwick, 2003 for a detailed exposition of these arguments). The picture that emerges is one of the CEO as a calculating professional who places personal gains above shareholder welfare since it is traditionally believed that unrelated diversification destroys shareholder value (Amihud and Lev, 1981; Fama, 1980; Fama and Jensen, 1983). This view of CEOs presupposes that they have the power and the influence to make those choices on behalf of the organization. However, they do have to surmount the obstacles of diligent corporate governance mechanisms that are in place precisely to guard against such excesses (Monks and Minow, 1995). Therefore, it is critical to identify the conditions under which CEOs have the power to propel the organization into the unrelated diversification trajectory.

CEOs operate within a context of the relationships they have built up with other managers, directors, major customers, suppliers, and others. We refer to this context as their *social embeddedness*. This social embeddedness is a function of formal arrangements such as position(s), extent of shareholdings, as well as of informal factors like age, length of tenure, and education. It brings with it a set of contacts, expectations, obligations, social reciprocity norms and interrelationships with the other actors. Based on all of the above, CEOs obtain a degree of *overt power* (that is formal and explicitly defined) over their fellow-actors. In addition, *covert power* resulting from informal sources of power or influence, also enables the CEO to shape the decision-making process in ways that further their interests or desired goals (Barkema and Pennings, 1998). Since diversification is a quintessentially strategic activity, CEOs can use their power bases to implement their own vision of the strategic direction of the firms that they lead. While the bases of overt and covert power are manifold,

of particular interest are attributes such as the incidence of CEO duality and the length of CEO tenure because these dimensions have been shown to be quite important in determining the power of CEOs (Finkelstein and Hambrick, 1996).

CEO duality. Duality (where the CEO of organization also serves as the chairperson of the board of directors) confers the CEO with a great degree of formal authority and consequently overt power. It is an important governance variable that has already been widely investigated as an indicator of CEO power over the board (Boyd, 1995; Finkelstein, 1992; Rediker and Seth, 1995). It has become almost axiomatic in the literature on good corporate governance practices to separate the roles of CEO and chair of the board. If the two roles are split between two individuals, the chair is expected to exercise greater diligence and weigh a wide range of alternative strategies before determining the value of unrelated diversification. On the other hand, the CEO who is also the chair of the board of directors will have formal authority, as well as greater influence over the board's governance process, since s/he is in a better position to appoint sympathetic candidates to the board and to shape the information that the board reviews (Boyd, 1994). Such undue influence may increase the overall level of CEO power and influence. This power and influence will manifest itself in strategic decisions exclusively initiated by the CEO and top management. Under these circumstances, it is plausible that a CEO will have wider latitude to employ unrelated diversification strategies that may generate personal gains.

While duality accords the CEO substantial power to shape diversification strategy in most of the developed country contexts where it has been studied, it may be less salient in settings such as India. A study by Dutta (1997) reports that roughly 70% of the largest firms in the country are family-controlled businesses,⁵ a feature not widely prevalent in developed countries. Given this unique dimension of shareholder composition in India, CEO duality is more the norm than the exception (Ramaswamy, Veliyath and Gomes, 2000) and the family-nominated CEO often doubles as the chair of the board as well. Thus, the idea of "private gains" itself becomes rather moot since the earnings of the company directly impacts the wealth of the family and the CEO-chair. Arising from this ownership structure in the Indian context, CEOs who hold dual positions may not necessarily be persuaded to adopt unrelated diversification strategies any more than CEOs who do not hold such dual positions. Unless such a diversification strategy is likely to clearly yield common benefits, there is no significant motivation for a chair-CEO in this context to pursue such a course. Consequently, it can be argued that in settings such as this, the individual influence of duality on corporate diversification choices would be inconsequential.

CEO tenure. Tenure is a measure of covert power since it reflects influence rather than formal authority. Longer tenure institutionalizes exchange relationships and makes them a part of the governance process (Barkema and Pennings, 1998). With longer tenure, a CEO is able to set norms, precedents, and standardize protocols and practices. Tenure is associated with increased social embeddedness including denser social exchange relationships with elaborate and diffuse patterns of obligations among the members of the top management team, centrality in the communication network and an institutionalization of governance arrangements that reflect the CEO's preferences (Barkema and Pennings, 1998). With longer tenure, a CEO is also able to make key appointments, and over time, have allies

in strategic positions that will support him/her in critical decisions. Tenure also makes the CEO the most central person in organizational communication networks, thereby increasing his/her influence. For example, many studies set in western contexts (Gomez-Mejia and Wiseman, 1997) have found that CEOs with longer tenures are likely to obtain higher levels of compensation than those that have shorter tenures, given the dynamics of CEO-board relationship that more experienced CEOs are likely to establish. Along similar lines, it can be argued that this base of power can be used by the CEO to implement corporate strategies without much opposition from the board.

While this might be true in a western context where the ownership patterns are such that CEOs are largely professional managers recruited or promoted to their positions through well-established corporate governance practices, it is not true of countries like India where the family wields substantial influence in CEO choices (Dutta, 1997). Irrespective of organizational tenure, the CEO enjoys fairly unrestricted domain over key corporate strategy decisions from the perspective of the board. Thus, CEO tenure in and of itself may not carry the same significance with respect to diversification strategy choices as it does in western contexts. Therefore we do not expect to see any systematic pattern of association between the length of CEO tenure and the nature of unrelated diversification strategies pursued by the firm.

1.2.2. Board composition and corporate diversification. The board of directors is probably the most effective mechanism for both influencing and controlling top management decisions so as to ensure that shareholder interests are protected (Boyd, 1994; Zald, 1969).

Outside directors. A pivotal determinant of the power of a board to exercise its oversight responsibility is the proportion of outside directors. While inside directors bring company specific knowledge and experience to the job, it is widely believed that external (outside) directors are more capable of playing the role of unbiased arbiters in key organizational decisions. Thus, a greater incidence of outside directors is believed to dampen the possibility of collusive behavior involving the board and the top management team. Given their unbiased nature, it is expected that outside directors can prove to be useful objective arbiters of corporate direction. Hence, an increased proportion of outside directors increases the board's ability to be properly objective (Fama, 1980; Fama and Jensen, 1983). This results in greater monitoring and vigilance, and consequently a lesser likelihood that CEOs will implement strategies in a relatively unchallenged fashion and get excessively compensated for their efforts (Walsh and Seward, 1990).

Although logical in countries with transparent corporate governance practices and professional management, there is reason to believe that the insider versus outsider dichotomy will be less relevant in contexts where large family owned conglomerates control significant sectors of the economy. India offers an example of such a context where external directors, although technically chosen from outside the organization, tend to have ties to the managers and owners of the firm due to the social structure and family histories (Dutta, 1997; Garg and Parikh, 1986; Heuze-Brigant, 1996; Lawler et al., 1995). Outside directors are less likely to exercise their power to change the course of managerial decisions because these appointments are mostly reciprocal. Since family controlled conglomerates account for close to 60 % of the economy (Ghemawat and Khanna, 1998), firms make mutually

acceptable appointments by trading one “outsider” for another (i.e., direct interlocking directorates). These appointments are more a function of family considerations and societal status among the leading business families in the country rather than selections based on merit. Thus, although “outside” directors do serve on corporate boards, they are unlikely to influence diversification decisions in quite the same way that outsider-dominated boards are known to do in the U.S. or the U.K. As Dutta (1997) observes, among Indian businesses, “as a general rule, outside directors usually represent some internal family or financial interest (. . .), the board rubber stamps its approval of actions or proposals of the business family shareholder or patriarch” (p. 160). Thus, in the Indian context, it can be postulated that the proportion of outside directors on the board would not have a significant bearing on the level of unrelated diversification pursued by the firm.

Foreign directors. While the insider v. outsider dichotomy has received the most attention in studies that have focused on the power of boards especially in the U.S. context, the role of foreign directors is getting an increasing scrutiny since the level of cross-border investment flows has increased significantly (Useem, 1998). The presence of foreign directors on the board of an organization is another dimension that dramatically alters the ownership-control equation. It provides the foreign investors with a tangible direct representation that can be leveraged to influence the strategic direction pursued by the organization. The role of foreign directors in this regard is particularly unique. Viewed within the context of organizations in developing countries, this role assumes greater importance. Foreign director representation on the board brings with it numerous benefits (Shekar, 1991). The participation of foreign directors sends a clear signal of a firm’s intention for global expansion. Typically, firms that are seeking to establish a presence in global markets embrace foreign technologies or align themselves with foreign competitors and may want to internationalize their governance structure as a signal that the management is serious about its internationalization efforts.

Foreign directors possess unique knowledge and understanding of various overseas strategic market areas a firm is interested in. Their knowledge and expertise may become invaluable as a firm pursues its expansion moves. These outsiders are quite likely to have different levels of knowledge of company strategies (Chen, Farh and MacMillan, 1993). To the extent that owners or their representatives (in this case foreign directors) possess knowledge and expertise they would be more capable of guiding strategy-making, monitoring the top management team and evaluating strategic directions of top management (Fama and Jensen, 1983; Geletkanycz and Hambrick, 1997). They can play the role of effective monitors by using their position as experts to dampen value-destroying moves such as diversification originating from selfish managerial interests.

2. Method and results

We concluded that the use of hypotheses testing in this paper was untenable for at least two reasons. First, we had neither enough consistent theoretical reasoning nor reliable empirical evidence from studies that have examined developed country settings to develop defensible hypotheses for testing in emerging market contexts. As mentioned before, the empirical results are a mixed bag and do not offer clear support to the Khanna and Palepu

(1997) thesis that unrelated diversification is associated with positive performance effects in emerging markets.

Second, in contrast to the direction of the expected links between CEO/board power and corporate strategy (specifically unrelated diversification) in developed country settings, we argue that proxies for the power of CEOs and boards will have very little impact on corporate strategy in the Indian context. Therefore, if we were to have adopted a hypothesis testing approach, we would have been forced to test the null (i.e., duality, tenure, ratio of insiders to outsiders on the board will *not* be related to strategy). Although testing the null is acceptable when the phenomenon of interest requires such an approach (Cohen, 1988, 1990), it raises related issues of effect size and power. In order to estimate the size of the sample required to detect these effects, one would need to first obtain a reasonable estimate of the size of the expected effect. This was not easily possible in our case. We faced a significant hurdle because (a) there is a real dearth of studies that have examined these linkages especially in the contexts that we were interested in, and (b) the few parallel studies in developed country contexts did not offer enough statistical information (e.g., first order partial correlation coefficients) needed to compute average expected effect size. Thus, absent any reliable effect size estimate, we would have unwittingly opened ourselves to the possibility to Type I or II error. Given these considerations, we chose to frame this study as an exploratory one.

2.1. Study setting and sample

For several reasons related to the scope of this study, the Indian manufacturing sector was chosen as the setting. First, India's economy has been classified as emerging, thus placing it in a category of countries that are in contrast with contexts such as the U.S. where most prior studies of corporate governance and diversification have been focused. This consideration is important for advancing our understanding of corporate governance and diversification on a more comprehensive scale. Second, there are unique corporate governance features that are uncommon among developed economies. The corporate governance systems in Indian firms often include institutional investors that function much along the same line as their counterparts in the developed economies, as well as investors such as banks and banking companies that owe their allegiance both to the government and the client firms with whom they conduct business transactions. When considered together, India offers the opportunity to examine the influences of these external as well as internal constituents on unrelated diversification.

Firm level data on diversification were obtained from the annual database published by the Centre for Monitoring Indian Economy (CMIE). This database, which covers the largest firms in India, is built on raw data obtained from reports that all companies file with the Registrar of Companies, a federal agency. CEO duality and tenure as well as outside director and foreign director measures were obtained from annual reports filed by the firms in the sample and supplemented by data from the CMIE database. As part of the process, adequate checks were employed to ensure accuracy of data reported. CMIE is acknowledged as the leading provider of data on Indian firms to the major financial agencies, banking organizations and research institutions worldwide.

Details pertaining to firm ownership were obtained from reports produced by Credit Rating and Information Services of India Ltd. (CRISIL). This agency has been promoted by

leading Indian financial institutes such as the Industrial Credit and Investment Corporation of India Limited, Unit Trust of India, and Asia Development Bank and a host of nationalized and foreign banks and credit services. The equity structure data were prepared from raw data published by the Ministry of Industry. The data used in the analysis had fairly high accuracy because they represented information collected from largely public sources that had regulatory oversight over the firms in the sample (CMIE, 1993).

The original sample was made up of the top 150 manufacturing firms in the country during the 1993–1994 period. This ranking, similar to the Fortune 500 in the U.S., is published annually by *Business Today*, a leading business magazine in India. The companies were ranked on the basis of their scores on a composite set of six equally-weighted criteria (ROE, ROI, ROS, growth in assets, growth in profits and growth in sales). The firms in the sample represented industries that corresponded to four two-digit SIC categories: chemical and allied products (53% of the sample), industrial machinery and equipments (29% of the sample), textile and mill products (13% of the sample) and food and kindred products. The sample was restricted to manufacturing firms given past empirical evidence that the diversification motives and patterns of service firms may be markedly different from manufacturing organizations (Capar and Kotabe, 2003; Contractor, Kundu and Hsu, 2003).

It must be acknowledged that the choice of the top firms always carries with it the risk of survivor bias. However, given our objective to decipher broad patterns of linkages between internal and external governance constituents and unrelated diversification, we believe that this choice is prudent. This sample accounts for roughly 70% of market capitalization and a similar proportion of gross domestic product. Thus, it may be argued that these firms are most representative of the Indian milieu. There was the additional concern that inclusion of medium and small scale firms, mostly privately held, would raise other concerns about data access and reliability.

2.2. Variables

Unrelated diversification. Unrelated diversification was measured using both the Herfindahl index approach (Acar and Sankaran, 1999; Herfindahl, 1950) and the entropy index approach (Hall and St John, 1994; Hoskisson et al., 1993; Jacquemin and Berry, 1979; Palepu, 1985). Segment-wise sales data were obtained from CMIE (1993). This formed the basis for computing an unrelated diversification Herfindahl and entropy index respectively. The correlation analysis showed that the entropy index and Herfindahl index were highly correlated (>0.98). To avoid needless duplication we only reported the models using the entropy measure of unrelated diversification.

Ownership measures. Ownership was measured in terms of the proportion of equity held by the two groups identified earlier. Thus we derived two ownership measures as follows, institutional investors and mutual funds (*Institutional Ownership*), and banks and banking companies (*Bank Ownership*). Diversification measures were lagged by a year in comparison to the independent variables. This was done to parallel the design used by other researchers (e.g., Denis, Denis and Sarin, 1997) so as to prompt comparability of findings across studies.

CEO duality and tenure. CEO duality (*CEO Duality*) is a dummy variable that would be one if the CEO is also the chair of the board, and zero otherwise. CEO tenure (*CEO Tenure*) measures the number of years the CEO has served in that particular company.

Board composition variables. By dividing the number of outside directors by the total number of directors we obtained the proportion of outside directors (*Outside Directors*), and by dividing the number of foreign directors by the total number of directors we obtained the proportion of foreign directors (*Foreign Directors*).

Controls. Group membership, firm size, economic performance and financial leverage were used in this study as control variable.⁶ Given that several studies on diversification in emerging markets (Chhibber and Majumdar, 1999; Claessens et al., 2003; Khanna and Palepu, 2000a, 2000b; Lins and Servaes, 2002) have explicitly modeled group affiliation, it was added as a control variable in this study to enable cross-study comparability. Firm size is relevant when considering diversification strategies since companies pursue scale and scope advantages in stages (Chandler, 1962), and furthermore, a company must reach a certain size threshold to establish its headquarters, a prerequisite for multi-business firms where the headquarters needs to manage its multiple businesses effectively (Goold, Campbell and Alexander, 1994). The extant literature also suggests that firm performance may influence diversification moves (Chatterjee and Wernerfelt, 1991; Markides and Williamson, 1994). Therefore it was essential to control for the impact of economic performance on diversification. Finally, given the theoretical linkage between leverage and diversification as discussed in the literature (Kochhar, 1996; Kochhar and Hitt, 1998) and the strong relationship between India's business groups and banking institutions, it was necessary to control for leverage to ensure it was indeed those corporate governance variables identified in this study, not the debt level, that were driving diversification moves.

Group membership (*Group*) was captured using the classification scheme adopted by CMIE and used extensively by Khanna and Palepu (2000b) in their studies on India. CMIE defines a group affiliated organization on the basis of the relationships, cross-shareholdings, family ownership, and other governance structures that bind two or more organizations together. Khanna and Palepu (2000b) have already established the efficacy of this classification scheme in their study and hence its reliability was assumed. Out of the 83 firms, 64 (77%) belong to a group. Firm size (*Firm Size*) was measured as a logarithmic function of the total assets of the firm in 1994, the base year for computing the diversification measures used in the study. Financial leverage (*Leverage*) was measured as a three-year (1991–1993) average of the firm's debt to equity ratio. Economic performance (*Performance*) was measured as a three-year (1991–1993) average of return on assets. Table 1 provides the univariate descriptive statistics and the correlation matrix to the study variables.

2.3. Results

Because the formal data analyses employed multiple linear regression methodology, we first conducted preliminary assessments to ensure that properties of our data set confirm with key assumptions of multiple linear regression methodology. Variance Inflation Factor

Table 1. Descriptive statistics and correlation matrix.

Variables	Mean	S.D.	1	2	3	4	5	6	7	8	9	10
1. Institutional ownership	11.66	10.25										
2. Bank ownership	9.03	8.06	0.306***									
3. CEO duality	0.28	0.45	0.013	-0.049								
4. CEO tenure	17.39	12.87	-0.075	0.143	0.345***							
5. Outside directors	0.79	0.19	-0.013	-0.005	-0.054	0.070						
6. Foreign directors	0.11	0.17	-0.218***	-0.074	0.037	-0.095	0.109					
7. Group	0.77	0.42	0.085	0.072	0.081	0.182*	-0.100	-0.556***				
8. Firm size	2.56	0.43	0.208*	0.218**	-0.114	0.138	-0.365***	-0.195*	0.303***			
9. Performance	0.18	0.07	0.026	-0.071	0.123	0.037	0.022	0.099	-0.045	-0.372***		
10. Leverage	3.24	10.63	-0.046	-0.103	-0.103	0.052	-0.078	-0.125	0.115	-0.102	-0.196*	
11. Unrelated diversification	0.36	0.44	-0.172	0.327***	-0.021	-0.230**	-0.041	-0.137	-0.025	0.290***	-0.303***	-0.013

$N = 83$.

Institutional and bank ownership are equal to the proportion of equity held by institutional investors and banks, respectively. CEO duality is a dummy variable equal to 1 if the CEO is also the chair of the board and 0 otherwise. CEO tenure is equal to the number of years the CEO has served in the firm. Outside and foreign directors are equal to the proportion of outside and foreign directors, respectively. Group is a dummy variable equal to 1 if the firm belongs to a group and 0 otherwise. Firm size is equal to the logarithm of total assets in 1994, performance to the 1991–1993 average return on assets and leverage, to the 1991–1993 average debt to equity ratio. Unrelated diversification is the entropy measure of unrelated diversification.

Two-tailed tests.

* <0.10, ** <0.05, *** <0.01.

Table 2. Regression results.

	Model 1		Model 2		Model 3		Model 4	
	β	t	β	t	β	t	β	t
<i>External constituents</i>								
Institutional ownership			-0.014	-3.809***			-0.015	-3.821***
Bank ownership			0.020	3.346***			0.019	2.955***
<i>Internal constituents</i>								
CEO duality					-0.034	-0.247	0.042	0.354
CEO tenure					0.009	1.632	0.004	0.892
Outside directors					0.023	0.067	0.122	0.390
Foreign directors					-0.498	-1.744*	-0.713	-2.276**
<i>Controls</i>								
Group	-0.109	-0.844	-0.112	-0.961	-0.247	-1.540	-0.293	-2.011**
Firm size	0.242	1.724*	0.250	1.818*	0.202	1.173	0.270	1.574
Performance	-1.505	-2.061**	-1.212	-1.771*	-1.594	-2.226**	-1.126	-1.610
Leverage	-0.001	-0.238	0.001	0.191	-0.000	-0.650	0.000	0.017
Constant	0.093	0.227	-0.002	-0.05	0.220	0.337	-0.010	-0.015
R^2	0.139		0.304		0.219		0.374	
Adjusted R^2	0.095		0.249		0.134		0.287	
Incremental R^2			0.165		0.080		0.235	
Model F statistic	$F_{4,78}$	3.157**	$F_{6,76}$	5.525***	$F_{8,74}$	2.593**	$F_{10,72}$	4.296***
Incremental F statistic			$F_{2,76}$	8.972***	$F_{4,74}$	1.885	$F_{6,72}$	4.490***

$N = 83$

Institutional and bank ownership are equal to the proportion of equity held by institutional investors and banks, respectively. CEO duality is a dummy variable equal to 1 if the CEO is also the chair of the board and 0 otherwise. CEO tenure is equal to the number of years the CEO has served in the firm. Outside and foreign directors are equal to the proportion of outside and foreign directors, respectively. Group is a dummy variable equal to 1 if the firm belongs to a group and 0 otherwise. Firm size is equal to the logarithm of total assets in 1994, performance to the 1991–1993 average return on assets and leverage, to the 1991–1993 average debt to equity ratio. Unrelated diversification is the entropy measure of unrelated diversification.

All incremental comparisons are against Model 1.

Standard errors are corrected for heteroscedasticity (White, 1980).

Two-tailed tests.

* < 0.10, ** < 0.05, *** < 0.01.

(VIF) and tolerance statistics indicated that multicollinearity was not a significant threat. White's (1980) correction for heteroscedasticity was performed as a measure of precaution.

Formal analyses consisted of two steps. First we tested the full model with unrelated diversification as dependent variable and all independent variables and controls entered as explanatory variables. We then also tested a series of constrained models, Model 1 uses only controls, Model 2 adds external governance constituents' variables (shareholders) in addition to the controls, Model 3 includes internal governance constituents' variables (CEOs

and boards) in addition to the controls. Testing incremental F statistics of each unconstrained model against a constrained model allowed us to assess the relative significance of external and internal constituents in a post-hoc fashion. Table 2 reports all four multiple linear regression models.

Model 4 provides evidence that pressure-resistant owners (institutional investors and mutual funds) have a negative impact, while pressure-sensitive owners (banks and banking companies) have a positive impact on unrelated diversification strategies. CEO duality, CEO tenure and outside directors do not have any significant impact, but foreign directors have a negative impact on unrelated diversification strategies. None of the controls has a significant impact, except group membership, which has a negative impact on unrelated diversification strategies. As argued by Lins and Servaes (2002), being affiliated to a group might already provide access to internal markets, which would make the quest for unrelated diversification unnecessary. Thus, the negative finding is in consonance with recent findings.

We gained additional insights by comparing unconstrained regression models with constrained ones. Table 2 reports three incremental F statistics for a comparison of Models 2, 3 and 4 against Model 1, which contains only controls. Clearly, the inclusion of external constituents variables (Model 2) does explain significantly more variance in the dependent variable above what was accounted for by the controls (Model 1), whereas the inclusion of internal constituents variables (Model 3) does not explain significantly more variance. Including both external and internal constituents variables, Model 4 does explain significantly more variance than Model 1, the basic control model. But it is clear that the incremental explanatory power comes from external constituents variables. Reinforcing this conclusion are two findings not reported in Table 2. When comparing Model 4 against Model 2 and Model 3, Model 4 explains significantly more variance than Model 3 ($F_{2,72} = 8.896$, significant at the 1% level, with $\Delta R^2 = 0.155$) but fails to explain significantly more variance than Model 2 ($F_{4,72} = 2.011$).

3. Conclusions and discussion

The findings reported here underscore the fundamental relevance of country context in determining the dynamics of diversification strategy. Not only are there important differences in corporate governance mechanisms, the way in which the mechanisms function seems to differ across contexts as well. For example, although many studies set in Western economies (e.g., the U.S. and the U.K.) have suggested that CEOs holding dual positions or those having long executive tenures are likely to garner significant power over strategy choices (Boyd, 1994), our study reports that CEO duality and tenure have no significant impact on firm diversification moves. Along similar lines, despite the calls for greater levels of outsider representation on boards, we find no evidence of a relationship between monitoring or control exercised by the board over CEOs in strategy making and the presence of outside directors. It is plausible that there are shades of gray when it comes to transporting findings across contexts.

In the Indian context, dimensions such as the incidence of family ownership, salience of social ties between CEOs and directors on the board, and the unique selection mechanisms at play in choosing directors (Dutta, 1997) are all vitally important in influencing

corporate governance practice. Such differences in governance practices raise several important questions. What roles do outside directors play in effective strategy making? Has their strategy-making effectiveness been hampered or facilitated by the institutional environment? In contrast, foreign directors appear to exert influence to reduce unrelated diversification. It seems that despite the geographical distance that separates them from the company on whose board they sit, they play an active role in the strategy-making process.

Finally, the findings primarily relate to large manufacturing firms, a limitation imposed by the specific sample that was used in this study. However, many strategic management researchers have called for more fine-grained studies on the evolutionary patterns of organizations rather than static snapshots in time. Perhaps the findings of this study will offer some impetus toward more longitudinal designs to address questions such as changes in diversification posture and the accompanying changes in performance or the changes in governance mechanisms and concomitant changes in organizational strategy.⁷ While significant insights have been gained through penetrating studies of these central players separately, it is now important to consolidate the theoretical advances and empirical insights from these sub-streams of research and integrate them into a more comprehensive theory of corporate governance and its influence on firm strategy (Golden and Zajac, 2001). This paper represents a preliminary step in that direction.

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Notes

1. Given that it is often customary to include both organizational managers and select external representatives on the board, it is acknowledged that its inclusion under the umbrella of "internal" constituents is largely for the purpose of theoretical parsimony. However, the incidence of CEO duality and the nature of the CEO-board relationship could provide further support for this classification.
2. We wish to thank an anonymous APJM reviewer for bringing to our attention the fact that market failures exist even in developed countries. Thus, it is possible that under some circumstances, unrelated diversification might yield benefits in developed markets.
3. We wish to thank an anonymous APJM reviewer who pointed out that there could be a point of inflection in the relationship between the conflicting, at times adversarial, position of the pressure-resistant shareholders and management resulting in an inverted U shaped relationship between conflict and firm performance. However, testing this form of linkage will have to await the availability and collection of more fine-grained data that this study could gather.
4. We wish to thank an anonymous APJM reviewer for calling our attention to the role of debt-financed mergers and acquisitions and its significance for the relationship between banks and corporate managements of diversified firms in India.
5. It must be emphasized that these are family-*controlled* and not wholly family-owned firms. By virtue of founding and family lineage, these firms are de facto run by the family although other external investors and institutions do indeed invest in them.
6. We did consider including dummy variables for the four broad primary product domains: chemical and allied products, industrial machinery and equipments, textile and mill products and food and kindred products. However, we decided against doing so because we did not envisage that such an approach would add substantively to our understanding of the drivers of unrelated diversification. Further, one could argue that the very definition

of unrelated diversification is posited on the mix of industries and hence adding dummies would raise concerns about definitional dependence and endogeneity in the models.

7. We wish to thank an anonymous APJM reviewer for bringing this limitation of our study to our attention and also highlighting a potential future research opportunity in the process.

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