

# THE EXTERNAL TIES OF BOARDS OF DIRECTORS AND THE EXECUTION OF DIRECTORS' FUNCTION

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## บทคัดย่อ

งานวิจัยนี้มุ่งศึกษาอิทธิพลของกรรมการบริษัทเอกชนผู้ซึ่งในขณะเดียวกันได้ดำรงตำแหน่งในบริษัทเอกชนอื่น ๆ หรือองค์กรอื่น ๆ ด้วยต่อการทำหน้าที่ในการกำกับดูแลผู้บริหารของบริษัท การทำหน้าที่ให้คำปรึกษาต่อผู้บริหารของบริษัท และการทำหน้าที่หาข้อมูลข่าวสารจากบุคคลภายนอกบริษัท ผลลัพธ์ที่ได้จากการวิเคราะห์ทางสมการถดถอยชี้ว่าการดำรงตำแหน่งในหลายบริษัทหรือหลายองค์กรมิได้ทำให้กรรมการมีส่วนร่วมในการทำหน้าที่ในบริษัทหลักลดลง แต่การดำรงตำแหน่งในบริษัทอื่น ๆ และองค์กรอื่น ๆ กลับช่วยให้กรรมการสามารถทำหน้าที่ต่าง ๆ ได้ดีขึ้น การดำรงตำแหน่งในบริษัทอื่น ๆ และองค์กรอื่น ๆ เปิดโอกาสให้กรรมการสามารถทำหน้าที่หาข้อมูลข่าวสารจากบุคคลภายนอกบริษัทได้มากขึ้น เปิดโอกาสให้กรรมการได้เรียนรู้ทักษะการบริหารงานจากบริษัทอื่น ๆ หรือองค์กรอื่น ๆ ซึ่งกรรมการสามารถนำความรู้นี้มาใช้ในการทำหน้าที่กำกับดูแลผู้บริหารของบริษัทหลักได้

## Abstract

The present paper examined the influence of the external network ties of boards of directors on their execution of the monitoring, advising, and environmental scanning function. The results from multiple regression analysis indicated that the external ties of boards of directors did not decrease directors' involvement and contribution on the focal firm's board; rather such ties enhance the execution of directors' function. Ties provided opportunities for directors to scan the external environment and acquire knowledge and skills which can be used to monitor and provide advice on the focal firm's board.

**Keywords:** External Ties, Board of Directors, Monitoring, Advising, Environmental Scanning

## INTRODUCTION

Boards of directors have powers and duties in directing the company to maximize the value of the business for the shareholders. Although there has been considerable attention on the influence of boards of directors, there are few empirical studies which examine how directors make meaningful contributions on the firm's board. By integrating various perspectives on a board of directors' functions, the present study proposes that the directors' functions can be classified into three broad categories, labeled monitoring, advising, and scanning the external environment.

First, the mainstream research on board of direc-

tors has been based on Agency theory which contended that the major responsibility of directors is to monitor top managers on behalf of shareholders. Effective monitoring helps curb managers' opportunism resulting in lower agency costs and higher firm performance (Fama, 1980; Fama & Jensen, 1983; Hillman & Dalziel, 2003). Second, management literature on boards of directors (e.g. Carpenter & Westphal, 2001; Johnson, Daily, & Ellstrand, 1996; Westphal, 1999) proposed another function of directors as the provision of advice and counsel on strategic issues to CEOs and the top managers of the company. Advice from directors helps top managers broaden the range of strategic options, providing a firm with strategic alternatives that aid in effective de-

cision making, thus, enhancing firm performance. Third, the Resource Dependence theory (Pfeffer & Salancik, 1978) emphasized the external roles of boards of directors as a mechanism to cope with environmental uncertainty. Directors can cope with uncertainty through activities such as scanning the external environment for opportunities and threats (Miller, 1987; Murphy & McIntyre, 2007). Through environmental scanning, directors can effectively make strategic decisions to avoid external constraints, increase the firm-environmental fit, thus, enhancing firm performance.

However, in practice, the degree to which directors execute their function on the firm's board is vague. Directors often face problems of setting priorities and allocating their time since they typically hold management positions in other organizations and many directors serve on more than one board (Lawler, Finegold, Benson, & Conger, 2002). Agency and corporate governance theorists indicated that serving on two or more boards simultaneously may place excessive burden on a director. As a result, they may not be able to execute their functions as a director on the focal firm (Ferris, Jagannathan, & Pritchard, 2003). On the other hand, resources dependence and social network theorists indicated that serving on boards of other organizations creates external ties or linkages between the firms and other organizations that directors sit on. These ties link directors into a social class network. Within the network, directors can acquire information on the general business environment (Useem, 1984), learn about different practices of other organizations (Carpenter & Westphal, 2001), and even utilize their ties to acquire resources critical to firm performance (Pfeffer & Salancik, 1978).

The conflicts in previous studies may be a result of an incomplete understanding of the effects of external network ties of a board of directors on the execution of directors' function. It is possible that the external network ties of directors may enhance some aspects of board functions, such as advising and environmental scanning, but they may have negative effects on other aspects of board functions such as monitoring. It is interesting to examine the extent to which directors, who have ties or linkages to other organizations, actually monitor, advise, and scan the external environment as previous theories have indicated.

## LITERATURE AND HYPOTHESES

### **The External Network Ties of Boards of Directors and the Monitoring Function**

Agency theory posited that the board of directors is a particular mechanism designed to acquire information that helps shareholders to effectively monitor the behavior of its executives. However, there are several factors that limit the ability of directors who have external network ties to other organizations, to execute their monitoring function on the focal firm's board. First, serving on multiple boards places excessive burdens on directors. It may dissipate a director's time and attention, and undermine their ability to monitor executives at each board on which they sit (Ferris et. al., 2003; Lawler et al., 2002).

Second, directors who have external network ties to other organizations may be reluctant to monitor their executives since they possess less knowledge about top executives' performance and firm specific issues. Directors who serve on several organizations may have breadth of knowledge in various businesses, but may have limited knowledge on the day-to-day operations of the focal firm. Serving on several organizations' boards makes it difficult for directors to understand specific issues facing any one firm (Baysinger & Hoskisson, 1990).

Third, directors who have ties to other organizations may be reluctant to monitor their executives because of the relationships between directors and executives in the business elite network (Koenig & Gogel, 1981; Useem, 1984). The study of Westphal and Khanna (2003) indicated that directors who participated in monitoring and controlling activities that threaten the interests of executives on a particular board are more likely to be subjected to social sanctions not only on the focal firm's board but also on the other boards on which they sit. Once the directors experience social sanctions, they are less likely to monitor their executives and more likely to avoid future participation in elite-threatening activities. In addition, directors who are former CEOs or current CEOs of other organizations tend to identify themselves as CEOs. They are more likely to exhibit empathy to their executives; are reluctant to criticize them; restrict board vigilance, amplify managerial discretion, and diminish their willingness to monitor them (Hillman,

Nicholson, & Shropshire, 2008). Moreover, in many firms, CEOs dictate the selection of directors. CEOs can appoint individuals with whom they have preexisting social ties on the firm's board. These ties inhibit the director's willingness to monitor executives on behalf of shareholders, resulting in a passive board (Adams & Ferreira, 2007; Ruigrok, Peck, & Keller, 2006; Westphal, 1999; Zajac & Westphal, 1996). Therefore, the present study hypothesizes that

*Hypothesis 1: The number of a director's external network ties is negatively related to his/her execution of the monitoring function.*

### **The External Network Ties of Boards of Directors and the Advising Function**

The external network ties of boards of directors play an important role in the execution of the advising function. With external network ties, directors are in a position to acquire diverse knowledge and skills from other organizations. The diversity of advice from directors' outside experience broadens strategic alternatives to the firm, renders debate about the firm's current strategy, enhances adaptation to the alternative strategy, and improves firm performance. The more the outside experience, the greater the possibility that directors can be exposed to and be aware of different practices, the higher their involvement in boardroom discussions (Shropshire, 2010).

Directors are more likely to use knowledge and skills developed from their experience from other organizations to advise the focal firm's board (Carpenter & Westphal, 2001). Chua and Petty (1999) indicated that a firm that has director ties to previously ISO accredited firms is more likely to receive better advice and achieve ISO accreditation. Shropshire (2010) indicated that the likelihood that a director will transfer knowledge to the focal firm is partly contingent upon the breadth of a director's outside experience. The higher the degree of knowledge and skills, the more directors are involved in giving advice to executives on strategic issues (Gabrielsson & Winlund, 2000). The more external ties there are, the more likely it is that directors can possess the breath of (or functional area) knowledge and skills that can be used to advise on the focal firm's board. Therefore, the present

study hypothesizes that

*Hypothesis 2: The number of a director's external network ties is positively related to his/her execution of the advising function.*

### **The External Network Ties of Boards of Directors and the Environmental Scanning Function**

The external network ties provide opportunities for directors to extend the range of a director's network, acquaintances, and experience. The wider range of network provides opportunities for a director to scan the environment and share information among its interest groups. By serving in multiple organizations, directors have opportunities to acquire significant, valuable, and diverse information and opinions on a very timely subject matter which allows the board of directors to formulate policies that can capture opportunities and avoid threats (Useem, 1984). Therefore, the present research hypothesizes that

*Hypothesis 3: The number of a director's external network ties is positively related to his/her execution of the environmental scanning function.*

## **RESEARCH METHODOLOGY**

### **Sample**

Since the present study attempts to examine the relationships between the external ties of boards of directors and the execution of their function, the target population of the present study is managing directors of companies and public companies registered with the Department of Business Development (DBD), Thailand. With a large number of registered companies, the present study randomly selected managing directors of 500 companies that are registered with DBD as the sampling frame. The selected samples were contacted via telephone asking whether they would like to participate in the survey. If yes, the questionnaires were sent to the directors via fax, email, or by mail. Managing directors who hold positions in several organizations were asked to respond for only

one company. In total, 203 questionnaires were returned which represents a response rate of 40.6%. However, due to the quantity of missing data, only 170 questionnaires were usable.

## Measurement of Variables

### *The External Network Ties of Boards of Directors*

A director's external network ties refer to a director who simultaneously holds positions in other organizations. Other organizations refer to both privately-owned companies and other non-profit organizations. The number of a director's external network ties was measured by one plus the number of privately-own companies, and plus the number of non-profit organizations in which a director hold positions.

### *The Monitoring Function*

The monitoring function was measured by five items in the questionnaire. Directors were asked to rate the extent to which they have executed the monitoring functions on a five-point scale (1 = minimal to 5 = very much so). The questions included to what extent they criticize strategic proposals put forth by the executives, to what extent they formally evaluate executives' performance, to what extent they make a decision to hire, to fire, and to compensate executives (Fama & Jensen, 1983).

### *The Advising Function*

The advising function was measured by four items in the questionnaire. Directors were asked to rate on a five-point scale (1 = minimal to 5 = very much so). The questions included to what extent do you take the initiative in defining a company's goal and direction, to what extent do you collaborate with executives and top managers in the formulation of corporate strategy, to what extent do you suggest strategic alternatives to executives and top managers whenever problems occur, and to what extent do you answer executives' question regarding strategic issues whenever they want (Adams & Ferreira, 2007; Forbes & Milliken, 1999; Johnson et al., 1996; Westphal, 1999; Zahra & Pearce, 1989).

### *The Environmental Scanning Function*

Environmental scanning was classified into two major variables based on Bourgeois (1980). The first

variable involved scanning for the *general* environment, namely, trends in economic, demographic, socio-cultural, political, and technological factors. The second variable involved scanning for the *task or specific* environment, namely scanning for information regarding the trends or change in the supplier sector, the customer sector, the competitor sector, and then government sector. Directors were asked to rate their interests in the nine components of the environment on a five-point scale (1 = low interest to 5 = high interest). Then, directors were asked to rate their frequency in scanning the environment from personal sources on a five-point scale (1 = once or less than once a year, 2 = quarterly, 3 = monthly, 4 = weekly, 5 = daily). The scores on directors' interests and frequency of scanning each environmental component were multiplied and averaged to form an environmental scanning index as follows (Hambrick, 1982; Daft, Sormunen, & Parks, 1988).

$$\begin{aligned} \text{ScGe} &= \Sigma (\text{InGe}_i \times \text{FGe}_i) / 5 \\ \text{ScTa} &= \Sigma (\text{InTa}_i \times \text{FTa}_i) / 4 \end{aligned}$$

Where ScGe is the general environmental scanning index, InGe is interest on components of the general environment, FGe is the frequency of general environmental scanning, ScTa is the task environmental scanning index, InTa is interest on components of the task environment, FTa is the frequency of task environmental scanning, and *i* is the component of the environment.

### *Control Variables*

The present study included five control variables in the model. First, size may pose different impacts on directors' functional execution. With different sizes, directors are expected to perform their functions differently. Therefore size measured by registered capital was included in the model. Registered capital data were obtained from archival data from the website of the Department of Business Development of Thailand. Second, a director's tenure was controlled in the model. The length of tenure reflects a directors' experience in strategic decision-making and firm performance. It could be associated with the director's ability to monitor and advise management (Carpenter & Westphal, 2001). A director's tenure was measured by the number of years that a director worked

in a company. Third, the director's education was added as a control variable in the model. The level of education may indicate knowledge pertinent to strategic decision-making. It may enhance the ability to monitor and advise CEOs on a board (Carpenter & Westphal, 2001). Thus, it is expected that the education of directors is positively associated with their execution of directors' functions. Fourth, a director who simultaneously holds management position(s) in the company (insider) was controlled in the model. The presence of insiders is positively related to board involvement in strategic decision making since insiders are more effective and provide better information flow within the boardroom (Judge & Zeithaml, 1992). An inside management position currently held by a director was coded as a dummy variable. It was coded as 1 when a director simultaneously holds other management position(s) within the company, and 0 otherwise. Finally, the quantity of stock that a director owns (percent) was used as a control variable in the model. A director's ownership may increase his or her motivation and involvement in the execution of directors' function (Westphal, 1999).

## RESULTS

Table 1 shows the results of the regression model on the effects of the number of a director's external network ties on the execution of the monitoring function. Inconsistent with the stated hypothesis, the regression results indicated that the number of a director's ties was positively associated with the execution of the monitoring function ( $p < .05$ ). Therefore, Hypothesis 1 was rejected.

**Table 1: Regression Model of the Monitoring Function**

Independent Variables	Hypothesis 1: Monitoring Model 1 <sup>a</sup>
1. Number of Director's Ties	0.08 (0.04)*
2. Registered Capital	0.00 (0.00)
3. Director's Tenure	0.01 (0.01)
4. Education	0.10 (0.08)
5. Director's Inside Position	0.07 (0.11)
6. Ownership	0.01 (0.00)***
Constant	3.21 (0.24)***

F	5.21***
R <sup>2</sup>	0.16

<sup>a</sup> Unstandardized coefficients are reported with standard error in the parentheses,  $n = 170$

\*  $p \leq .05$

\*\*  $p \leq .01$

\*\*\*  $p \leq .001$

Table 2 shows the results of the regression model on the effects of the number of a director's external network ties on the execution of the advising function. The coefficient of the number of director's ties was positive as expected; however, the relationship between the number of director's ties and the advising function was weak ( $p < .1$ ). The knowledge acquired from a director's ties had insufficient influence on the directors' execution of the advising function. Therefore, Hypothesis 2 was rejected.

**Table 2: Regression Model of the Advising Function**

Independent Variables	Hypothesis 3: Advising Model 2 <sup>a</sup>
1. Number of Director's Ties	0.06 (0.03)
2. Registered Capital	0.00 (0.00)
3. Director's Tenure	0.01 (0.01)
4. Education	0.14 (0.07)
5. Director's Inside Position	0.08 (0.10)
6. Ownership	0.01 (0.00)***
Constant	3.47 (0.22)***
F	6.31***
R <sup>2</sup>	0.19

<sup>a</sup> Unstandardized coefficients are reported with standard error in the parentheses,  $n = 170$

\*  $p \leq .05$

\*\*  $p \leq .01$

\*\*\*  $p \leq .001$

Table 3 shows the results of the regression model on the effects of the number of a director's external network ties on the execution of scanning for the general environment function and scanning for the task environment. The regression results provided strong support for the third hypothesis. As expected, the greater the number of ties that a director had, the wider the range of his (or her) connections, and the greater the opportunities for a director to scan the environ-

ment (Useem, 1984).

**Table 3: Regression Model of the Environmental Scanning Function**

Independent Variables	Hypothesis 5	
	General Environment	Task Environment
	Model 3 <sup>a</sup>	Model 4 <sup>a</sup>
1. Number of Director's Ties	0.75 (0.21)***	0.64 (0.29)*
2. Registered Capital	0.00 (0.00)	0.00 (0.00)
3. Director's Tenure	0.05 (0.04)	0.80 (0.05)
4. Education		1.28 (0.47)**
1.39 (0.63)*		
5. Director's Inside Position	0.34 (0.66)	1.43 (0.89)
6. Ownership	-0.02 (0.01)	-0.02 (0.01)
Constant	9.69 (1.40)***	11.05 (1.89)***
F	5.80***	4.09***
R <sup>2</sup>	0.18	0.13

<sup>a</sup> Unstandardized coefficients are reported with standard error in the parentheses, n = 170

\* p .05

\*\* p .01

\*\*\* p .001

## CONCLUSIONS AND DISCUSSION

Overall, the findings supported the effects of the number of director's external network ties on the execution of the directors' functions. First, for the monitoring function, the results from hypothesis testing were inconsistent with Lawler et al. (2002), and Ferris et al. (2003). The number of external ties of directors did not decrease a director's involvement and contribution on the focal firm's board; rather, such ties enhanced a director's monitoring activities. Ties provided opportunities for directors to acquire information and observe experiences in evaluating executives from other directors in the business network (Carpenter & Westphal, 2001; Koenig & Gogel, 1981; Westphal, 1999). The greater the number of ties, the more information and experience was employed in evaluating executives, and the greater were the opportunities for directors to execute their monitoring function.

Second, for the advising function, the regression results indicated that the number of director's ties was positively related to director's execution of the advis-

ing function; however the relationship was quite weak. Only the presence of knowledge is insufficient to influence directors' execution of the advising function. Directors must be able to combine their knowledge in various functional areas and apply them to provide advice to the firm's executives (Forbes and Milliken, 1999).

Finally, the findings highly supported the effects of the number of director's ties on environmental scanning. Consistent with Useem (1984), ties are mechanisms that directors use to scan the external environment. Ties help extend the range of a director's network, acquaintances, and experience. The greater the number of director's ties, the greater the opportunities for directors to scan the external environment (Useem, 1984).

## IMPLICATIONS AND RECOMMENDATIONS

The findings of this study revealed important implications for corporate governance theorists and business practitioners. First, for the corporate governance theorists, most literature on boards of directors state that the external ties of boards of directors diminish directors' involvement and contribution in the focal firm. Conversely, the present study found that the external ties of directors enhanced the involvement and contribution on the focal firm's board. Directors who served on two or more organizations did monitor, advise, scan the external environment more than directors who serve on only one board. Directors are more likely to realize positive externalities from other organizations in which they served – they acquire information, knowledge, and experience from sources external to the firm. Therefore, the proposition to limit the number of organizations that a director may serve should be reconsidered. For business practitioners, the findings indicated that the external network ties that directors possess were critically related to the execution of a director's function. Thus, directors should use these ties and apply knowledge, skills, and experiences acquired from other organizations to contribute on the focal firm's board. However, the present study does not recommend directors to increase the number of ties; rather, directors should use their existing ties to benefit the company.

## LIMITATIONS AND SUGGESTIONS FOR FUTURE RESEARCH

Several limitations of the present study must be acknowledged. First, the present study measured only the number of ties and the degree to which directors executed their functions. However, the quality of ties and the quality of directors' functional execution were unable to be assessed. Future research can be extended to examine the quality aspects of directors' ties and the quality of director's functional execution. For instance, under what conditions can ties facilitate the transfer of knowledge and practices between firms; or what types of transferred knowledge, information, and practices are critical to firm performance. Second, the present research accessed all of the data through a board of directors' survey questionnaire. The data acquired from only directors may not be accurate. There is a high possibility that directors may over-rate their contribution and perceptions of firm performance. Finally, since the present study is conducted in a Thai context, the results of the study may not be able to be generalized to other countries. Future research can be extended to examine the effects of the external ties of directors in other context.

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