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THE EFFECTS OF FIRM PERFORMANCE ON CORPORATE GOVERNANCE

M. Alix Valenti, University of Houston Clear Lake, e-mail: valenti@uhcl.edu
Rebecca Luce, Xavier University, e-mail: lucer@xavier.edu

ABSTRACT

Few management scholars would disagree that sound governance policies are desirable for organizations. A plethora of studies exist showing or attempting to show that companies that adopt good governance practices out-perform their competitors who do not follow suit. The underlying assumption of this research is that managers who steward organizational assets wisely will inevitably realize higher returns on those assets. Investors, customers, and other stakeholders are expected to reward such firms, contributing further to increased firm value. In this paper, we question this assumption and inquire whether the causality is in the opposite direction. We suggest that firm performance in prior years will influence the types of directors who might be nominated to the board and the governance structures adopted in subsequent years. We posit that better-performing firms will have the ability to attract higher quality outside directors who can further bolster the firm's attractiveness to investors. We expect performance will also affect board structure and incentive compensation to the CEO; we present alternative hypotheses to test these relationships. On the other hand, poor performance will lead to governance changes aimed at financial improvements for the firm. We propose CEO power and the presence of concentrated shareholdings and outside directors will intensify these relationships.

Corporate governance advocates and reformers claim that good governance policies are essential for high performance. Relying on agency theory, scholars and practitioners reason that if a company is paying attention to safeguarding the interests of its owners, the assets of the firm will be employed in a manner to minimize waste and maximize profitability, resulting in above average gains to shareholders. Several studies using a overall score of governance have found a relationship between governance and shareholder returns (e.g., Gompers, Ishii & Metrick, 2003), leading one commentator to observe that if companies with good governance are rewarded by better stock performance, "companies whose cost of capital [is] lower will be motivated to make . . . [governance] improvements" (Bradley, 2004: 10). When individual governance practices are examined, however, such as insider equity ownership (Dalton, Daily, Certo, Roengpitya, 2003) or executive incentive compensation (Tosi, Werner, Katz,, & Gomez-Mejia, 2000 the link to performance returns becomes less evident. Recognizing that agency theory alone does not adequately explain the relationship between governance and performance, resource dependence theory has been the basis of many studies where the research focuses on the board of directors as the governing body.

According to the resource dependence view, directors may have the ability to reduce environmental uncertainty by virtue of their network connections (Pfeffer & Salancik, 1978). A firm able to reduce environmental uncertainty, especially with regard to scarce resources, is in a better position to perform to its potential. The resource dependence perspective has also been

used as the underlying theoretical basis for studies examining changes in boards when external circumstances or internal needs of the firm change (Hillman, Cannella & Paetzold, 2000; Pfeffer, 1973). In the Hillman et al. (2000) study, the selection of directors to the boards of utility companies became more oriented to the for-profit sector when deregulation took effect. In Pfeffer's (1973) seminal study in this area, he predicted the experiences and contacts directors would possess based on the varying resource needs of hospitals. According to the resource dependence view, it is the backgrounds and network ties of directors that affect their ability to influence events in the firm's favor and/or to bring additional expertise to the boardroom. We employ the resource dependence view in our paper in a broad sense, as developed by Hillman and Dalziel (2003), to include the prestige and status of directors as well as their connections and expertise, as a basis for increasing their governance effectiveness.

This paper is intended to make two contributions to the literature examining the relationship between firm performance and governance. First, we take a fresh approach to the governance-performance question and develop a new model that may further explain the relationship by investigating a connection between prior performance of the firm and specific governance practices. In this regard, we take an expansive view of governance that includes both board structure and composition affecting directors' ability to monitor and supply resources to managers and to provide incentives to executives as rewards for good performance. Baysinger and Butler (1985) studied the relationship between prior firm performance and the boards of directors and found no relationship. In their study, however, the characteristic of the board examined was restricted to the independence of the board from management. We take a broader approach by looking at this relationship from a variety of angles and include moderating variables in our analyses. Second, we test our hypotheses using moderately sized publicly traded companies in the U.S. The context of publicly held moderately sized companies presents a different set of characteristics than large Fortune 500 or S&P 500 firms which are the focus of most governance research, including Baysinger and Butler (1985). By examining the prior performance-governance relationship in this type of firm, we expect to offer insights that are valuable to a larger swath of American managers in making governance related decisions.

LITERATURE REVIEW

Board Composition

From an agency perspective, outside directors are considered to be in a better position to monitor management because of their assumed independence from the company's managers and their expertise developed from prior experience (Mace, 1986). Additionally, outsiders are considered preferable because "insider-dominated boards imply problematic self-monitoring and particularly weak monitoring of the CEO, since the CEO is likely to be in a position to influence the insider directors' career advancement within the firm" (Zajac & Westphal, 1994: 125). Outside directors are also presumed to bring a level of impartiality in evaluating management's decisions (Baysinger & Hoskisson, 1990). Unlike insiders, outside directors' careers are less likely to be affected by the outcomes of their decisions and thus can arrive at more objective solutions (Rechner, Sundaramurthy & Dalton, 1993).

Despite the numerous studies on the appointment of outsiders to boards of directors, the empirical evidence fails to show any significant relationship between the practice and corporate outcomes. A meta-analysis review of 85 empirical studies involving more than 200 samples found no compelling evidence exists supporting a positive connection between board composition and leadership and performance (Dalton, Daily, Ellstrand & Johnson, 1998). In a similar meta-analysis, Rhodes and her colleagues found a small positive impact on financial performance when firms had either an insider or an outsider dominated board (Rhodes, Rechner & Sundaramurthy, 2000), and concluded that attempts to equally balance insider and outsider representation may negate the advantages of either an insider-dominated or outsider-dominated board.

According to agency theory, outside board members are also viewed as influential in engaging or promoting activities that enhance shareholder value, in addition to enhancing firm performance. Outsider-dominated boards are more likely to replace a CEO in times of poor performance (Weisbach, 1988) or to hire a replacement CEO from the outside (Borokhovich, Parrino & Trapani, 1996). Agency theory would also suggest that outside, independent directors would discourage the implementation of value-reducing activities such as anti-takeover defenses or increased diversification. Research has supported these some of these conjectures. For example, firms resisting the payment of greenmail have a higher proportion of outside directors on their boards (Kosnik, 1987). Brickley and his colleagues found that the average stock-market reaction to announcements of poison pills is positive when the board has a majority of outside directors and negative when it does not (Brickley, Coles & Terry, 1994). On the other hand, Hill and Snell (1988) actually observed a positive relationship between the influence of outsiders on the board and the emphasis placed on diversification. Further, contrary to expectations, no relationship was found between the number of outsiders and the commission of illegal acts (Kesner, Victor & Lamont, 1986). Thus, the presence of outsiders on the board may not affect overall performance or shareholder value, but may, in some cases, influence a specific strategic issue.

There has been some success in studies tying firm characteristics or environmental changes to the nature of directors using the resource dependence view as the underlying theory. Pfeffer and Salancik (1978) developed their resource dependence theory based on the open systems perspective which posits that the environment plays an important part in determining organizational effectiveness. One suggestion they offer for managing the environment is the appointment of external representatives to positions within the organization, specifically through the naming of outside directors to the board. Pfeffer (1973) argues that changes in the membership of a corporate board is a direct response to changes in the environment. Baysinger and Butler (1985) characterized the board as consisting of an instrumental component of independent directors who provide a source of "managerial wisdom" and external linkages which in turn enable the firm to achieve measurable performance dividends (1985: 110).

Hillman et al. (2000) found that utility companies made changes in the directors serving on their boards to make them more responsive to competitive conditions when the industry underwent deregulation. Hillman, Shropshire and Cannella (2007) found that organizational characteristics predicted board composition, in this case, the likelihood of the presence of female directors on firm boards. While Baysinger and Butler (1985) and Hillman (2005) found a

relationship between the nature of directors and firm performance, (outsider status in the former study and political connections in the latter), most of the studies utilizing resource dependence theory have not found or have not examined a relationship between board and director attributes and subsequent firm performance.

CEO Duality

Agency theorists advocate separation of the CEO and board chair positions as necessary to avoid managerial entrenchment and to curb the CEO's power (Mallette & Fowler, 1992). When the CEO is also the chair, it becomes more difficult to replace the CEO for poor performance (Goyal & Park, 2002). According to agency theory, duality "signals the absence of separation of decision management and decision control (Fama & Jensen, 1983: 314). Unitary leadership can lead to opportunistic behaviors and the expense of shareholders (Fosberg, 1999). Conversely, separation of the CEO and chair positions facilities objective evaluation of organizational and managerial performance (Weidenbaum, 1986).

Some studies have found support for the separation of the two positions. Research in the banking industry revealed that cost efficiency and return on assets were lower for chairman-CEO banks and were positively related to nonchairman-CEO ownership (Pi & Timme, 1993). In an integration of previous studies, Boyd (1995) found a weak negative relationship between firm performance and duality. When controlling for environmental differences, however, CEO duality was found to be positively related to performance in environments with low munificence and high complexity. In another study, however, when the CEO occupied both the chair and the president position, stock market performance suffered (Worrell, Nemec & Davidson, 1997).

The mixed results of these studies support Finkelstein and D'Aveni's (1994) characterization of the issue as a "double edged sword." They note that the agency problems with CEO duality are often mitigated by the resource dependence advantages associated with the CEO's ability, as chair, to provide important information to the outside directors about firm operations and finances, as suggested by resource dependence theory.

Incentive Compensation

In the context of CEO pay, an agency problem exists when an agent, such as a CEO, has established an agenda which conflicts with the interest of the stockholders. Agency problems are most likely to occur when an executive has no financial interest in the outcomes of the decisions made (Boyd 1994). Therefore, one way to avoid agency problems is to reward executives on the basis of financial returns to shareholders (Kerr & Bettis 1987). Thus, agency theory suggests that CEO pay should be closely tied to firm performance.

Despite the theoretical rationale for the link between pay and performance, empirical evidence provides little support for the relationship between CEO compensation and performance (Barkema & Gomez-Mejia, 1998; Jensen & Murphy, 1990; Tosi, Werner, Katz & Gomez-Mejia, 2000). Several explanations have been put forth to explain these results. Crystal (1991) contends that CEOs will resist efforts to reduce their pay even when the firm is performing poorly. For example, if the firm is facing a high degree of uncertainty regarding performance outcomes, it is less likely that CEO pay will be tied to performance (Miller, Wiseman & Gomez-Mejia, 2002). Others adopt a social explanation for CEO compensation, pointing to the use of compensation consultants as the basis of compensation decisions and the

resulting "homogenization" of CEO pay regardless of performance (Finkelstein & Hambrick, 1996: 275).

Bloom and Milkovich (1998) argue that the relationship depends on the element of compensation. Base pay will not be affected by incentives (Gray & Cannella, 1997) especially after 1993 when the tax law effectively caps base pay at $1 million. Moreover, since almost 80% of the gain in CEO compensation is derived from stock options (Elson, 2003), one would expect to find a relationship between market-based performance measures and equity-based compensation (Baum, Sarver & Strickland, 2004: Mehran, 1995). Stock ownership by the CEO and the board significantly lowered the likelihood of resistance to a takeover attempt, suggesting that stock ownership is an effective tool in aligning management's interest with those of shareholders (Buchholtz & Ribbens, 1994).

Board Committees

Under U.S. securities law and exchange requirements, public corporations must establish an audit committee on their boards. Accordingly, studies have examined whether the membership of audit committees affect firm performance. Prior research has shown a positive relationship between the appointment of an accounting financial expert to an audit committee and a favorable market reaction (Defond, Hann and Hu, 2005). According to agency theory, this response may be due to the market's belief that the company's financial records will be more accurately monitored when an accounting financial expert sits on the committee. Resource dependence theory would suggest that the appointment of an accounting expert signals that the company maintains high standards in its financial reporting (Engle, 2005). Likewise, Van der Zahn and Mitchell (2008) found a positive association between the presence of audit committee members with accounting credentials and IPO first day returns.

Similar to the audit committee, the compensation committee is charged with oversight over company finances, specifically with respect to the pay awarded to top managers. Studies of companies in the U.K. have found a positive relationship between the existence of a compensation committee and performance (Main & Johnson, 1993; Weir & Laing, 2000). Since compensation committees exist nearly universally on U.S. boards, the emphasis of research on U.S. firms has been the composition of these committees. Most of the literature theorized that the presence of outsiders on the committee would predict lower CEO pay; however, empirical results were either equivocal (Daily, Johnson, Ellstrand & Dalton, 1998) or seemed to find the opposite, with the ratio of insiders negatively related to pay (Boyd, 1994). Conyon and Peck (1998), however, found a positive relationship between the proportion of outsiders on the compensation committee and both the amount of top management pay in the U.K. and the link between pay and firm performance. Belliveau, O'Reilly and Wade (1996) found that the social status of the CEO may affect compensation levels with CEOs having more status than their compensation committee chairs receiving higher levels of compensation. Other research suggests that if the CEO appointed members of the committee, they may be inclined to award higher levels of compensation to the CEO (Main, O'Reilly, & Wade 1994).

THEORY AND HYPOTHESES

Firm Performance and Board Composition

Hermalin and Weisbach (1988) suggested that shareholders will seek to replace inside directors with outsiders in order to provide better monitoring of management. Consistent with

their suggestion, Shivdasani (2004) proposes that board composition is affected by declines in financial performance because companies react to performance downturns by adding outside directors to the board who are willing to take corrective action, such as replacement of the CEO. Firms may also choose to add outsiders following periods of performance decline in order to provide new ideas, to add to the pool of knowledge, or to signal to stakeholders that operations are now under control (Pearce & Zahra, 1992). Davis and Thompson (1994) point out that the threat of lawsuits may also prompt the appointment of outside directors to exercise more control over management. In addition, while there is some dispute regarding the effect of board size on performance in general (e.g. Alexander, Fennell, & Halpern,1993; Yermack, 1996), evidence suggests that larger boards are preferable for smaller firms (Dalton, Daily, Johnson & Ellstrand, 1999) .

An alternative view suggests that in years in which firm performance declines relative to previous years' performance, board membership will decrease. The number of outside directors is likely to decrease because outsiders are more costly for the firm (Yermack, 1996). Pearce and Zahra's (1992) data showed that past poor performance is positively associated with smaller boards and fewer insiders, and Gilson (1990) reported that only 46 percent of outside directors remained on the board of firms following a bankruptcy or debt restructuring. These results are similar to those of D'Aveni (1990) who found that prestigious managers will leave a firm shortly before bankruptcy in order to avoid damaging their careers.

We suggest that when faced with potential loss of power due to the addition of outside monitors or with the threat of being fired, powerful CEOs will attempt to maintain the status quo and, therefore, new appointments to the board of directors will be minimized. Zajac and Westphal (1996) proposed that the source of power (with the CEO or with the board) would predict the selection of individual board members based on their prior experience and thus shape the composition and effectiveness of the board. They hypothesized that powerful CEOs will seek to maintain their control by selecting and retaining board members with experience on passive boards and excluding individuals with experience on more active boards. On the other hand, powerful boards will seek to maintain their control by favoring directors with a reputation for more active management and avoiding directors with experience on passive boards. Their research confirmed that powerful actors in CEO-board relationships can manage the composition of board membership. Thus, we suggest the following:

Hypothesis 1a: Following periods of declining performance, both the number of directors and the number of outside board members will decrease or remain the same; the power of the CEO will stengthen this relationship.

Firms that have experienced a period of unusually strong performance may be in a better position to recruit outside directors. An outside director's prestige is derived from a number of sources including the director's title and job position (D'Aveni, 1990). Outside directors with higher qualifications are those with backgrounds suggesting increased abilities to monitor management and/or contribute to strategic decision making within the firm (Hillman & Dalziel, 2003). They may also have the potential to exert influence on outside resource providers, such as financial institutions, or send signals to investors of the value of the firm. Research suggests that outside directors will seek to protect their reputations (Fama & Jensen, 1983); one way they can accomplish this is to identify themselves with successful firms and avoid associations with

firms that could damage their reputations. Companies may use the prestigious reputation of directors to the firm's advantage. For instance, Certo, Dailey and Dalton (2001) found that high status directors can send a signal of firm legitimacy and future success in initial public offering firms. Conversely, individuals will avoid serving as directors for poorly performing firms because of the potential stigma that could be transferred to the directors, thus causing their own reputations to suffer (Lester, 2008). Thus, consistent with our previous hypothesis, we posit that:

Hypothesis 1b: Following periods of improving performance, the size of the board will increase with prestigious outside directors added to the board.

Firm Performance and Duality

Finkelstein and D'Aveni (1994) posit that vigilant boards will prefer the CEO and chair position be separate in periods of good performance for several reasons. First, good performance increases CEO power and creates organizational slack, both of which lead to undesirable governance consequences such as entrenchment and opportunistic behaviors; second, in periods of good performance there is no need to create managerial efficiency through duality; finally, the board is less likely to remove a CEO after periods of good performance, with the increased potential for CEO entrenchment. In contrast, they argue that duality is preferable after periods of poor performance to convey a sense of unity of command and strong leadership. In times of financial distress, combining the roles may be preferable to enable the CEO to make critical decisions affecting the future of the organization (Harris & Helfat, 1998).

The relationship between performance and an independent chairperson is supported by Rechner and Dalton's (1991) findings which showed a strong difference in three accounting measures of performance between firms with independent structures and those with CEO duality. These results confirmed the hypotheses that firms with separate CEO and chair positions will consistently outperform firms with dual structures. Conversely, Boyd's (1995) research supports the conjecture that in times of uncertainty, characterized by low munificence or high complexity environments, the combined structure will be more effective. Boyd (1995) suggested that a resource scarce environment, such as is likely to exist following a decline in performance by the firm, may lead to duality so that the power in the firm can be consolidated for a faster, more unified response to the poor conditions.

Hypothesis 2a: Following periods of Improving performance CEO and chair position will be separate.

When performance of the firm has been unusually poor, the board has several options available to it in regard to the CEO's status. The board may choose to do nothing; it may choose to demote the CEO in some fashion as a penalty for the firm's poor performance; or the board may choose to fire the current CEO and appoint someone new to the position. Evidence exists that the stronger the board, the more likely that it will take serious action such as CEO dismissal if they are not satisfied with firm performance (Bhagat, Carey & Elson, 1999; Weisbach, 1988). In the case of stronger boards, directors are more likely to prefer separate CEO and Chair positions because duality represents less separation between management and control (Fama & Jensen, 1983) and can lead to CEO entrenchment (Mallette & Fowler, 1992). Thus we propose the following alternative hypothesis:

Hypothesis 2b: CEO and chair position will be separate following periods of declining performance; this relationship will be stronger where there is a high percentage of outsiders on the board.

Firm Performance and CEO Incentives

Executive compensation has come to be viewed as an internal corporate governance mechanism (Bilimoria, 1997; Finkelstein & Boyd, 1998). Neoclassical economists claim that because the objective of the firm is to maximize profits, executive compensation must be tied to firm profitability (Lewellen & Huntsman, 1970). Agency theorists emphasize that executive compensation can function to align managers' interests with those of shareholders through the use of incentives (Shleifer & Vishny, 1997). In contrast, if executive pay is shielded from performance risk, there is little incentive for the executive to pursue risky, but potentially profitable, strategic alternatives (Hill & Snell, 1989). Thus, incentive pay regulates managerial action in the absence of direct supervision (Wiseman & Gomez-Mejia, 1998).

Incentives to CEOs are typically divided into short-term and long-term, with short-term awards based on meeting annual organizational performance targets (Ellig, 2002). Based on research showing that managers tend to prefer accounting based performance measures while principals would rather use market based measures, Wiseman & Gomez Mejia (1998) theorized that the use of accounting based measures would increase managerial expectations of achieving performance goals. Applying their model and assuming that CEO compensation, to the extent that it is performance based, will be higher following periods of good performance, we propose the following:

Hypothesis 3: Following periods of improved performance, the CEO's annual bonus will be increased; the increase will be higher when performance is measured by accounting measures.

While agency theory suggests that contingent compensation has a desirable motivational property to engage in activities that will maximize profits, researchers also point out its negative effect in causing managers to bear a disproportionate share of firm risk, leading to risk reducing behavior that is contrary to shareholder interests (Bloom & Milkovich, 1998; Sundaramurthy, Rhodes & Rechner, 2005). This problem is exacerbated when incentive pay includes stock options or restricted stock. Long-term awards that are tied to equity have less value when share price declines, thus reducing the executive's overall compensation. Share price volatility also reduces the ability to make any accurate predictions about future value (Eisenmann, 2002). Given that managers prefer stable, risk-free income (Gray & Cannella, 1997), incentive pay consisting of equities would be least desirable in unstable or uncertain environments. Examining a sample of initial public offering firms, Beatty and Zajac (1994) found that riskier firms were less likely to include stock options in their executive's pay.

The power and influence of the CEO is well-recognized; as Harrison, Torres and Kukalis (1988) noted, much of the CEO's power may lie simply is his role as CEO. As CEOs become more powerful, they are able to entrench themselves in the formal positions of authority and increase their control of the corporation over time (Salancik & Pfeffer, 1977). Thus research has focused on the influence of the CEO on his compensation. For example, Hambrick and Finkelstein (1995) suggested that in managerial firms, where CEO power is not curbed by

outside investors, CEO pay increase were more likely. Westphal and Zajac (1994) found that CEO influence was positively related to compensation and negatively related to the implementation of long-term incentive plans. CEO compensation was also found to be related to institutionalized sources of power, such as tenure or a dual structure (Elhagrasey, Harrison & Buchholz, 1998). Accordingly we hypothesize:

Hypothesis 4: Following periods of declining performance, the inclusion of stock options and stock grants to the CEO compensation package will decrease; the relationship will be more pronounced where CEO power is high.

Firm Performance and Committee Membership

While Sarbanes-Oxley does not require an accountant to sit on the audit committee, it does require the committee to include a financial expert. To satisfy this requirement companies will want to attract an accountant or CFO to the board due to the likely favorable market reaction of such an appointment (DeFond, Hann & Hu, 2005). However, the pool of available accountants is limited (McGee, 2005), and many qualified candidates may be reluctant to serve on boards for risk of being sued (Beresford, 2005). As a result, the ability to attract directors with accounting expertise will depend, in part, on the financial soundness of the company. In addition, nominating an accounting expert to the board, and most likely, to the audit committee, signals that the firm is concerned with avoiding fraud and placed high importance on the role of the audit committee. Conversely, shareholders of firms with past performance losses are less likely to demand a high level of scrutiny of the firm's finances and thus will be less concerned with the caliber of the audit committee membership (Klein, 2002).

Hypothesis 5: Following periods of increasing performance, there will likely be an accounting expert on the board's audit committee.

METHODS AND RESULTS

Sample

Most of the extant literature on governance focuses on large U.S. companies. Governance in mid-sized corporations has been largely understudied, although it is garnering increased attention (e.g., Gabrielsson & Huse, 2002; Gabrielsson & Winlund, 2000). Lynall, Golden and Hillman (2003) contend that boards formed early in the firm's life cycle are apt to set the tone for future boards of directors. If this is the case, choices of directors at this time are decisions that are of substantial importance for the future of the firm. Medium-sized companies face some disadvantages compared to their larger corporate counterparts in that they are often not considered as competitive or resourceful and may not, therefore, receive fair treatment when it comes to access to capital, for instance (Castaldi & Wortman, 1984). Borch and Huse (1993) agree. They must consider how to best make strategic decisions in competitive environments such as exist today and such firms "seldom have the economic or political power to control their environment" (1993: 23).

Mace (1986) identified the board of directors as an under-utilized resource that could supplement limited managerial knowledge and experience in the smaller enterprise (also see Jain & Gumpert, 1980). Borch and Huse (1993) point to the ability of directors to become more involved in the strategic decision making of smaller companies due to the lack of complexity

compared to the typical large corporation. Directors can also be of particular assistance for such companies in that they can bring social network connections to firms that reduce the transactions costs of doing business that are apt to be higher when firms are smaller and lack the reputation of the large firm (George, Wood & Kahn, 2001). Castaldi and Wortman (1984) and Jain and Gumpert (1980) note the problems inherent in medium-sized companies' ability to recruit the desired directorial talent. In light of the reforms of Sarbanes-Oxley, demand for well qualified directors has only made this difficulty greater. In this sense, we offer here a conservative test of our hypotheses, in that medium-sized corporations are likely to face more challenges in finding the types of directors we predict.

We selected a sample of 120 companies listed on the NASDAQ. This sample stemmed from a larger random sample of corporations used to test governance theory. While there are some fairly large companies listed on this exchange, for the most part, companies traded on the NASDAQ represent firms much smaller, based on sales, than those of the Fortune 1000. We found that the averages sales for our sample population was approximately $1.4 billion. According to CNN.money.com, 2007 revenue for the smallest firm in the Fortune 1000 was $1.6 billion. Thus, it appeared that our sample represented a reasonable sample of small to mid-sized firms. After eliminating several firms for missing or incomplete data, our study covered 90 companies.

Variables and Analyses

In each of our models, improvements or declines in performance are the main predictor variables. When selecting the appropriate performance variables, we note that many measurements of performance have been used in the governance literature and it is generally recognized that no one measure is universally ideal (Cameron, 1986; Venkatraman & Ramanujam, 1986). We follow a traditional approach in using both accounting measures (ROA and ROE) and market measures (returns to shareholders and P/E ratios) (Hoskisson, Hitt, Johnson & Moesel, 1993). Specifically, we examine whether the change in these measures from one three-year period (2000-2002) to the following (2003-2005), determined using a difference score, will have the predicted effects on board composition and structure and CEO incentives.

Moderating variables include CEO power and the percentage of outsiders on the board. CEO power was measured by a composite variable taking into account both CEO tenure and the percentage of the board appointed by the CEO. CEO tenure is predictive of power because the CEO's influence over firm operations increases as his years of tenure increase and the CEO becomes better able to control governance decisions due to their leadership position (Wright, Kroll & Elenkov, 2002). As noted by Ocasio (1994), longer tenure leads to increased legitimacy of the CEOs authority and ability to maintain power. While CEO tenure is correlated with the number of board members appointed by the CEO, directors who are appointed by the CEO are like to feel an obligation to the CEO (Boeker, 1992; Wade, O'Reilly & Chandratat, 1990), thereby enhancing the CEO's power even if tenure is not relatively long.

The percentage of outsiders was measured by the number of non-employee or former employee directors divided by the total number of directors.

Control variables were included to account for institutional ownership, firm size, and actual performance. The percentage of shares owned by institutional or large blocks of shareholders was added as a control variable as external owners apply pressure on CEOs to

appoint independent board members (Huse, 2000). Firm size, operationalized as the log of sales in thousands of dollars, was also added as a control variable as board structure and CEO compensation are often related to firm size.

Several models were estimated for each of the hypotheses using both general linear regression and logit regression analyses, depending on the nature of the dependent variables, which are more fully described with respect to each model. Partial summary statistics and correlation tables for Hypotheses 1 and 4, which were supported, are provided in Tables 1 and 2.[i]

Table 1: Summary Statistics

	Mean	Std. Deviation
Change in Number of Directors	-.2335	1.8918
Change in Number of Outsiders	-.5730	1.9001
Option Grant (no. of shares)	823.4	2027.56
Return on Equity	-13.1452	65.70340
Change in Return on Equity	20.6458	148.64920
Market Return	65.431	205.432
PE Ratio	13.437	61.963
Log Sales	5.2616	.90678
Percentage of Outsiders	.7476	.17254
Salary (000s)	448.303	233.850
Bonus (000s)	500.697	918,.96
Stock (000s)	408.315	1092.709
Option Grant in Prior Year	741.6	1237.86
CEO Power	10.4072	9.35563
Institutional Ownership	.2456	.18190

Hypothesis 1a predicted that declines in performance would result in a decrease in the number of directors and a decrease in the number of outside directors. Two models were estimated using linear regression, using the number of directors and the number of outside directors as the dependent variables. Negative change to market return predicted both a decrease in the overall number of directors and a decreased in the number of outsiders. However, this relationship is less likely to occur in larger boards with more outsiders. Market return was marginally significant and positive with respect to a decrease in the total number of directors, but was no longer significant when CEO power interaction variable was added. However the Change in Market Return coefficient remained significantly negative at $p<.001$ suggesting that CEO power has little effect on the decrease in number of directors following a decline in performance. Significant results for all estimated models are reported in Table 3.

Insert Table 3 about here.

In Model 2, when interaction variable for CEO power was added, the Change in the PE ratio became significant suggesting that CEO power moderates the relationship between outside directors and performance; more powerful CEOs are able to reduce the number of outsiders

following periods of performance decline. The coefficient remained significant on the Change in Market return with or without CEO power interaction variable. Thus there was partial support for Hypotheses 1a.

To test hypotheses 1b, we relied on prior studies to characterize prestigious directors. Baysinger and Butler (1985) describe the instrumental component of the board as consisting of directors who provide more than monitoring of and advice to management. They are the lawyers, financiers, and consultants who are a source of managerial wisdom and can therefore assist in decision-making as well as provide links to resources outside the firm (Baysinger & Butler, 1985: 110). Similarly, in Hillman, Cannella, & Paetzold's (2000) typology of board functions, the role of support specialists would include lawyers and bankers who are able to provide specialized expertise. Accordingly, we set the dependent variable as the number of lawyers or directors with a financial connection on the board and estimated a model using ordinary regression; in a second model we estimated a logit model with whether or not a lawyer or financier is a member as the dichotomous dependent variable. In neither model were any of the performance variables significant. Therefore there was no support for Hypothesis 1b.

Hypotheses 2a and b were tested using logit regression with the dependent variable equal to 1 if the CEO and chair position was separate. None of the performance change variables were significantly related to CEO duality, although market return was significant at $p<.05$. Not surprisingly, CEO power was significant and negative in every model, suggesting that the more powerful the CEO, the less likely the CEO and chair position will be separate.

Hypothesis 3 and Hypothesis 4 were tested using ordinary regression. While previous improvements or declines in performance produced no significant effects on subsequent short-term rewards, an increase in ROE was positively associated with stock option awards. In addition, both ROE and ROA were negatively related to the number of shares underlying options. Hypothesis 3 was not supported and Hypothesis 4 was partially supported.

Using logit regression to test Hypothesis 4, whether or not an accounting expert was a member of the audit committee following periods of improving performance, we found no significant relationships and thus no support for this conjecture.

DISCUSSION

Hermalin and Weisbach (2003) point out that studies of boards of directors, such as those just mentioned, examine the relationship between boards of directors and subsequent firm performance, treating boards as if they were an exogenous variable. Many fewer studies examine predictors of board characteristics than the outcomes of board characteristics. Hermalin and Weisbach (2003) suggest that the study of factors that affect the characteristics of the board are also important to our understanding of firm governance and may more accurately reflect the positioning of board variables in our research models. In this paper, we study the effect of prior firm performance on changes in board characteristics and other governance structures.

The results suggest that performance effects on board composition are more dramatic when there has been an downward change in the firm's performance. None of the performance variables, both accounting and market, were in themselves predictive of a decline in the number of directors or outsiders on the board. However, when performance was measured as a change in performance over a three year period from the previous three-year period, the result was fewer

board members, and fewer outsiders. One might argue that the overall size of boards has on average declined largely in response to governance experts' call for smaller, more dedicated boards. With respect to smaller firms, however, relatively larger boards are preferable (Dalton, Daily, Johnson & Ellstrand, 1999). Our results showing a negative relationship between the size of the board and a decline in board size suggests that larger boards are less inclined to reduce their board size even after periods of declining performance.

Other predictions of our hypotheses were not demonstrated. Neither the presence of a prestigious director or an accounting expert on the audit committee seems to be influenced by previous performance. In the former case, it may be that our measures of prestige do not take into account all of the facets of member reputation. Previous studies have included the number of other board seats held by the director and the member's equity ownership as indicia of status (Udueni, 1999). In the latter case, while, as hypothesized, accounting experts may prefer to hold membership on boards of financially sound firms, companies experiencing declines in performance may seek out financial experts to assist in turning the company around.

Lack of support for either Hypothesis 2a or 2b suggests that phenomena underlying the explanation for both propositions may be present. In some cases, improving performance negates the need for CEO duality while in other cases, the CEO is rewarded for performance gains by promotion to board chair. The strong relationship between tenure and CEO duality suggests that CEO power may be a more compelling determinant of board structure.

Results for the relationship between performance and CEO compensation were also mixed. Neither accounting nor market performance appeared to be significantly related with the CEO's annual bonus. Lack of support for this hypothesis was somewhat surprising as bonuses are typically based on meeting short-term financial targets. In contrast, improvements in performance as measured by ROE were positively related to stock option grants, suggesting that CEOs may be more willing to accept long-term risk if they perceive that their companies' futures hold promise.

Overall, our findings continue to follow the pattern established by prior studies: the relationship between performance and individual governance practices is weak, at best, regardless of the causality. With respect to board composition, social capital and network influences may be a much more important determinant of board membership than monitoring concerns. While agency theory offers a primarily economic explanation of board appointments and suggests that performance should be the ultimate dynamic in board composition, lack of empirical support suggests directors are selected based on social ties to the management team (Westphal, 1999) or have common associations within the same social group (Galaskiewicz & Wasserman, 1981; Useem, 1980).

The relatively small size of the sample and focus on SMES may also explain the absence of support for our hypotheses. Future studies expanding both the scope of the research as well as tailoring both the performance and governance variables to match the characteristics of smaller companies. Despite these limitations, our study contributes to the extant literature in that it suggests that the results of large-corporation studies may apply in the same way to small and mid-size firms.

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	Option Award	Return on Equity	Change in ROE	Log Sales	Percent of Outside Directors	Salary	Bonus	Stock Award	Option Award Prior Yr	CEO Power	I Ow
Option Award	1.000	-.184	.582	.032	.050	.054	-.026	-.122	.083	-.168	
ROE	-.184	1.000	.082	.333	.123	.059	-.131	-.236	-.082	.026	
Change ROE	.582	.082	1.000	-.138	.088	-.076	-.164	-.145	.018	-.133	
Log Sales	.032	.333	-.138	1.000	.346	.468	.235	.144	.053	-.046	
% Outsiders	.050	.123	.088	.346	1.000	.200	.215	.189	.036	-.064	
Salary	.054	.059	-.076	.468	.200	1.000	.315	.225	-.027	-.177	
Bonus	-.026	-.131	-.164	.235	.215	.315	1.000	.352	.332	.080	
Stock	-.122	-.236	-.145	.144	.189	.225	.352	1.000	-.143	.068	
Option Prior Yr	.083	-.082	.018	.053	.036	-.027	.332	-.143	1.000	-.060	
CEO Power	-.168	.026	-.133	-.046	-.064	-.177	.080	.068	-.060	1.000	
Inst. Ownership	.126	-.360	.026	.054	.178	.149	.231	.319	.126	-.103	

Table 2: Correlations

Table 3: Regression Results

	Decrease in the number of Directors	Decrease in the number of Outsiders	Grant of Stock Options
Return on Equity			-.344**
Change in ROE			.629***
Return on Assets			-3.436**
Market Return	.245*\+		
Change In Market Return	-.402***	-.401**	
PE Ratio			
Change in PE Ratio		-.404*	
Log Sales			.242*
Percentage Outsiders			
Number of Directors	-.488***		
Number of Outsiders	-.330**		
Salary			
Bonus			
Stock Grant			-1.766+
Option Grant Prior Year			
CEO Power			-.272*
Power/interaction variable			
Institutional Ownership	.235*	.221*	
	n=89 R^2=.35	n=89 R^2=.18	n=90 R^2=.459

[i] Summary statistics and regression results for non-supported hypotheses will be provided upon request.