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The impact of board capital and board characteristics on firm performance

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A B S T R A C T

The purpose of this study is to investigate the effects of board capital on the relationship between CEO duality, board dependence, managerial share ownership and performance. We argue that board capital (the ability of board members to perform manager-monitoring activities and to provide advice and counsel to management) varies across board members. Highly qualified board members will be better at monitoring management and constitute a more valuable resource for firms. Based on a sample of U.S. companies listed in the Compustat S&P 500 and using both resource dependence and agency theories, we predict and find that CEO duality and board dependence negatively affect performance and that board capital mitigates the negative effects. We also predict and find that managerial share ownership positively affects performance and that board capital strengthens this positive relationship. The results are consistent with the view that firms benefit from board capital in terms of outside directors' ability to monitor managers and provide advice and counsel to managers.

1. Introduction

Agency theory has been the most dominant approach used to examine the effects of boards of directors and managerial share ownership on firm performance. According to this theory, information asymmetry causes managers to behave opportunistically in order to maximize their own interest at the expense of shareholders. Jensen and Meckling (1976) suggest that monitoring and incentives mitigate managers' opportunistic behavior. In large organizations, corporate governance mechanisms, particularly boards of directors, serve to ensure that firm assets are managed efficiently and in the interests of shareholders and to mitigate the consumption of perquisite and other non-pecuniary benefits by managers or any other parties (Fama & Jensen, 1983). Jensen and Meckling (1976) propose that owning shares gives managers an incentive to invest in value-maximizing activities since they will share the proceeds of those activities. They argue that as the share ownership increases, managers' share of the cost of perquisite consumption increases, which will discourage them from engaging in opportunistic activities.

Although agency theory has been a very popular approach for previous empirical studies which examines the impact of various board characteristics and managerial share ownership on performance, these studies have reported mixed and often

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contradictory results (e.g., Garen, 1994; Hutchinson & Gul, 2004; Jensen & Murphy, 2004). One plausible explanation for these inconclusive results is that agency-based studies have focused only on the monitoring function of the boards. Although this stream of research is informative, it has ignored the resources which boards of directors provide to firms. Resource dependence theory (Pfeffer & Salancik, 1978) argues that when a firm appoints a member to a board of directors, it expects the directors to use their expertise, skills, and experiences to provide the firm with helpful advice and counsel (Pfeffer & Salancik, 1978; Westphal, 1999; Zahra & Pearce, 1989); enhance its legitimacy and reputation (Daily & Schwenk, 1996; Pfeffer, 1972); facilitate linkages to external organizations (Hillman, 2005; Pfeffer & Salancik, 1978); and support the firm's capacities for manager-monitoring, evaluation (Baysinger & Hoskisson, 1990), and strategic implementation (Dallas, 2001).

The purpose of this study is to investigate the effects of board capital on the relationship between corporate governance, managerial share ownership and firm performance, using a sample of U.S. companies listed in the Compustat S&P 500. We define board capital as outside directors' ability to use their skills, reputation, experience, expertise and knowledge to perform both manager-monitoring activities and provide advice and counsel to management (Chen, 2008; Hillman, 2005). We argue that the effects of corporate governance (i.e., board dependence and CEO duality) and managerial share ownership on performance will be affected by board capital. Further, we contend that while good governance and managerial incentives are necessary conditions for superior performance, they are not on their own sufficient to ensure superior performance – we also need to consider the capacity of the directors on the board to perform their duties because their ability to provide resources and monitor managers varies. For example, companies A and B have the same governance structure and managerial share ownership, but the members of company's A's board of directors have better skills and expertise than the members of company B. All else being equal, it is logical to expect that company A's board of directors will perform better at helping managers to perform their duties and conducting manager-monitoring activities than company B's board.

Consistent with previous studies (e.g., Gul & Leung, 2004; Hutchinson & Gul, 2004; Jermias, 2007; Tsui, Jaggi, & Gul, 2001; Weisbach, 1988), we predict that CEO duality and board dependence will have a negative effect on performance while managerial share ownership will have a positive effect on performance. However, the negative effects of CEO duality and board dependence will be mitigated by board capital. Furthermore, the positive effect of managerial share ownership will be strengthened by board capital. We find that board capital mitigates the negative effects of both CEO duality and board dependence. With regard to managerial share ownership, the results indicate that board capital strengthens the positive relationship between managerial share ownership and performance.

This study contributes to the existing literature on corporate governance in three ways. First, we use both resource dependence theory and agency theory to develop and test the hypotheses. The results increase our understanding of the relationship between board characteristics and firm performance. That is, good governance and managerial incentives alone are not sufficient for superior performance and should be supported by boards which capably perform their duties. Second, the findings suggest that both CEO duality and board dependence have a negative impact on performance. However, the negative effects are mitigated by board capital. Third, and with regard to managerial share ownership, our results is consistent with the view of agency theory in indicating that managerial share ownership provides an incentive for managers to engage in value-maximizing activities since they will share the proceeds of these activities. Furthermore, the results indicate that higher quality outside directors strengthen the positive relationship between managerial share ownership and performance.

Our results are important given that CEO duality remains a common practice in the US firms. Despite the recommendations of various recent corporate governance guidelines that the role of the CEO and the chairman of the board be kept separate (e.g., Business Roundtable, Principles of Corporate Governance, 2012; OECD Principles of Corporate Governance, 2004; Sarbanes-Oxley Act, 2002; The U.K. Corporate Governance Code, 2010; Toronto Stock Exchange Corporate Governance Guidelines, 1996), we find that the CEO is also the chairman of the board in 78% of our sampled U.S. firms. The high percentage of CEO duality is consistent with those of previous studies using a sample of large U.S. firms (e.g., Fich & Shivdasani, 2006; Rechner & Dalton, 1991). Furthermore, our results show that CEO duality is negatively and significantly associated with firm performance but the negative association is mitigated by board capital. The negative association between CEO duality and performance suggest that our findings support the corporate governance guidelines with regard to the separation of the CEO and the chairman of the board.

The results also support our hypothesis that board capital will mitigate the negative effect of board dependence on performance. They support the view that inside directors are unable to objectively evaluate management and are often influenced by top management. However, the negative effect of board dependence on performance can be reduced by having prominent individuals on the board of directors, such as the director of another S&P 500 firm, the CEO of another S&P 500 firm, a university professor, or a government officer. Finally, our findings indicate that managerial share ownership has a positive and significant effect on performance and that board capital strengthens this positive relationship. These findings are consistent with those reported by previous studies (e.g., Hilman, 2005; Hilman et al., 1999; Westphal, 1999).

The results of this study may have an important implication for practice. The positive effects of board capital on the relationship between CEO duality, board dependence, and performance suggest that firms need to devote greater attention to the quality of the individuals they appoint to their board of directors. This is important because many firms still appoint their CEO to the position of chairman of the board of directors. As mentioned, this was the case for the majority (78 percent) of our sampled firms. The high proportion of CEO duality, however, is consistent with the report by The Business Roundtable (an