BOARD COMPOSITION, QUALITY, & TURNOVER
RESEARCH SPOTLIGHT

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KEY CONCEPTS

- Companies recruit directors to bring a broad array of skills needed to advise and oversee the organization.

- Attributes of leadership, industry experience, accounting, and financial are highly valued. Many additional, diverse skills are also looked for.

- The labor market for directors is constrained by the available supply and demand of qualified individuals.

  Research suggests the director labor market is moderately efficient.

  Many sought-after skills are only modestly associated with performance and governance quality.
Fich (2005) studies the stock price reaction to the appointment of an outside CEO to the board.

Sample: 1,493 appointments, Fortune 1000 companies, 1997-99.

Finds a positive abnormal stock market reaction to appointment of active CEO (0.72%, 3-day period), compared to no significant reaction for outside directors who are not a CEO.

Conclusion: CEOs are perceived to be better directors.

These results are “consistent with the idea that outside CEO-directors are sources of unique expertise, industry contacts, and business acumen, and therefore are of greater value than outside directors of other occupations.”
Fahlenbrach, Low, and Stulz (2010) also examine whether CEOs are better directors.


Find no improvement in future performance (ROA, over 1-3 years).

Also, no impact (positive or negative) on monitoring, measured as: deal performance, sensitivity of CEO turnover to performance, or CEO pay.

Conclusion: CEOs are not better directors.

“We do not detect a discernable impact of CEO outside directors on high-level corporate decisions. … [It might be that] CEO directors are simply too busy with their day job to use their prestige, authority, and experience to have a substantial impact on the boards they sit on.”
O’Reilly, Main, and Crystal (1988) study the relation between director outside salaries and CEO pay.

Sample: 104 large companies, 1984.

Find a strong association between CEO pay levels and the outside pay level of directors, particularly members of the compensation committee.

Argue that, consistent with social comparison theory, committee members refer in part to their own pay as a benchmark for reasonable pay.

Conclusion: CEO directors are associated with higher CEO pay.
Faleye (2011) also studies whether CEO directors lead to higher CEO pay.

Sample: 3,217 CEOs, 2,105 firms, 1998-2005.

Finds CEO pay increases with the portion of outside directors who are CEOs.

CEO pay at these companies is also less sensitive to performance.

Conclusion: CEO directors are associated with higher CEO pay.

“CEO directors can distort executive incentives when they view themselves as members of the same group, overestimating the effort and skill requirements of their job and rationalizing higher compensation packages.”
Masulis, Wang, and Xie (2012) study the contribution of international directors to a board.


Find positive share price reaction to deal announcements when the target company is from the director’s home country.

Also find international directors have worse attendance records and provide worse monitoring.

Conclusion: International directors have mixed impact on board quality.

Foreign international directors [FIDs] “can utilize their international background … [to] benefit firms with substantial foreign operations or plans for overseas expansion. … On the negative side, the geographic distance between FIDs and corporate headquarters … [might] create obstacles for FIDs to effectively participate in the governance of U.S. firms.”
Dass, Kini, Nanda, Onal, and Wang (2014) measure the contribution of directors with related-industry expertise to performance.

Sample: 12,750 companies, 1990-2005.

Companies with directors who have related-industry experience trade at higher valuations (Tobin’s Q) and have better operating performance (ROA).

Conclusion: Directors with industry expertise improve performance.
• Faleye, Hoitash, and Hoitash (2018) also study the impact of directors with industry expertise on firm performance.

• Sample: S&P 1500 companies, 2000-2009.

• Find firms that are more difficult to monitor (because they require technical knowledge) are more likely to recruit directors with industry expertise.

• R&D spending at these firms increases, and is associated with higher patent approvals, lower earnings volatility, and higher firm value (Tobin’s Q).

Conclusion: Directors with industry expertise contribute to innovation.

“We show that board industry expertise reduces the earnings riskiness of R&D spending.”
Almandoz and Tilcsik (2016) perform a longitudinal study of banks to measure the impact of industry expertise on performance.

- Find banks whose boards have high portion of directors with banking experience are associated with higher probability of failure.
- Hypothesize that failure is due to overconfidence and premature consensus.

**Conclusion:** Directors with industry expertise might create higher risk.

“Under conditions of decision uncertainty, higher proportions of domain expert directors may actually lead to greater likelihood of organizational failure.”

Sample: 3,218 firm-year observations, 2010-2013.
- Rather than test the relevance of one skill, they examine how director skills cluster within a board and across companies.

Find average director has 3 skills.
- Common skills: finance, accounting, leadership.
- Less common: entrepreneurship, legal, risk, technology, etc.

Firms perform better (Tobin’s Q) when directors have more commonality and less diversity of skills.

Conclusion: Diversity of skills does not improve board performance.
PROFESSIONAL DIRECTORS

• Masulis and Mobbs (2014) study how board members with multiple directorships allocate their time.

• Sample: 17,525 directors, S&P 1500 firms, 1997-2006.

• Find:
  – Directors dedicate more effort to prestigious boards (meeting attendance).
  – They provide worse monitoring on prestigious boards (forced CEO turnover).
  – They are more likely to relinquish their least prestigious directorships.

Conclusion: Director perception of prestige might influence monitoring.

“Independent directors in their relatively more prestigious directorships are less willing to rock the boat.”
Evans, Nagarajan, and Schloetzer (2010) examine the impact of retaining the outgoing CEO on the board.

  - Matched pairs with firms that did not retain outgoing CEO on board.
- Find companies that retain nonfounder CEO as a director exhibit worse stock performance and lower value over following 2 years.
- No deterioration in performance if founder CEO remains on the board.

Conclusion: Outgoing CEO on board might hurt performance.

These results are “indicative of a powerful former CEO holding the influential board chairman position but lacking the pecuniary and nonpecuniary attachment to the firm that founder CEOs typically possess.”
• Quigley and Hambrick (2012) also examine the impact of retaining the outgoing CEO on the board.

• Sample: 181 CEO successions, high tech companies, 1994-2006.

• Find that outgoing CEO who retains chair position is more likely to restrict the strategic decisions of his or her successor: business divestitures, investment in R&D and advertising, and senior management turnover.

Conclusion: Outgoing CEO on the board might hurt performance.

“As long as the predecessor is on the scene a new CEO will tend to pursue an asymmetric agenda emphasizing new initiatives without the ability to drop old ones.”
Agrawal and Chen (2017) study director resignations.


Categorize resignations by reason:
- ~40%: deficient board functioning (director not given notice or information).
- ~25%: disputes with board or CEO over comp, hiring, or firing decisions.
- ~25%: disagree with strategy and financing decisions.
- ~20%: miscellaneous or unspecified.

Abnormal stock price returns around resignation (-2.6%, 3-day period).

Conclusion: Investors react negatively to resignations over a board dispute.
DIRECTOR RESIGNATIONS

• Fahlenbrach, Low, and Stulz (2017) also study director resignations.

• Sample: 16,497 directors, 2,282 companies, 1999-2010.

• Find that unexpected departures are associated with:
  – Lower stock price performance
  – Decreased operating performance (ROA)
  – Greater likelihood of future financial restatement or lawsuit

Conclusion: Unexpected resignations might signal governance problems.

“Directors have incentives to quit to protect their reputation or to avoid increases in their workload when the firm on whose board they sit is likely to experience a tough time either because of poor performance or because of disclosure of adverse actions.”
Harrison, Boivie, Sharp, and Gentry (2018) study the resignation of prominent directors.


Negative press coverage and downgrades from equity analysts are associated with higher director turnover, even in absence of future governance problems.

Conclusion: Directors resign to protect their reputations.
DIRECTOR TURNOVER AND LABOR MARKET

• Srinivasan (2005) study director turnover and the impact of job loss on future directorships.


• Find:
  – Director turnover is higher when firms have a major financial restatement (48% over 3-year period) compared to firms that have technical restatement (18%).
  – Directors more likely to lose other directorships.
  – Results are more pronounced for audit committee members.

Conclusion: Directors are penalized for poor oversight.

“Restatements are associated with labor market penalties for outside directors, particularly audit committee members.”
Arthaud-Day, Certo, Dalton, and Dalton (2006) also study turnover following adverse governance events.


Find:

- Executive turnover is twice as high following material restatement: CEO turnover (43% v. 23%); CFO turnover (55% v 31%).
- Directors and audit committee members are 70% more likely to turnover.

Conclusion: Directors and executives are penalized for poor oversight.

“Board member replacement may further help a firm restore legitimacy following a restatement. … Director turnover signals the firm’s commitment to preventing recurrences of similar problems.”
• Armstrong, Kepler, and Tsui (2017) study whether directors are held accountable for individual poor performance.

• Sample: 138,970 director elections, 2000-2012.

• Poor performance determined by: negative abnormal returns over their tenure, excess CEO compensation (for directors on comp committee), or weak internal controls (for directors on audit committee).

• Find these directors are more likely to gain than lose board seats.

Conclusion: Directors are not punished for individual poor performance.
Baer, Ertimur, and Zhang (2017) study whether executives of firms with governance failures are punished in the labor market for directors.

Sample: 1,864 executives, 1,035 companies, 2002-2014.
- Executives named as defendants in class action lawsuits: covers a broad range of governance failures (insider trading, GAAP violations, breach of duty, etc.).

Find these executives are more likely to gain outside board seats.

Shareholders react negatively to their appointment.

Conclusion: Executives are not punished for poor oversight.

“Firms may value directors who can bring valuable advisory skills to the board, even when there are concerns about their monitoring ability or integrity.”
CONCLUSION

• Many of the most sought-after criteria for directors—CEO experience, industry expertise, and board experience—are only modestly associated with director performance.

• Directors can be constrained in their monitoring if they do not have the time and willingness to engage with the company, or if interpersonal dynamics distract from their ability to function effectively.

• While we would expect directors to be penalized in the labor market for governance failures, this does not appear to be the case. A sitting director can gain more board seats without regard to performance on other boards.

• It is striking that there are few strong empirical that demonstrate an “effective” board. Why is this?


Timothy J. Quigley and Donald C. Hambrick. When the Former CEO Stays on as Board Chair: Effects on Successor Discretion, Strategic Change, and Performance. Strategic Management Journal. 2012.


