# Corporate Governance Characteristics of Most Admired Companies

**Obeua S. Persons**
Associate Professor of Accounting
School of Business Administration
Rider University
2083 Lawrence Road
Lawrenceville, NJ 08648
U.S.A.

## Abstract

*This study compared ten corporate governance characteristics including independent-director compensation of 50 world's most admired companies to those of their matched not-admired firms. Three significant findings are documented. First, most admired companies had less ownership concentration, a higher percentage of female directors, higher board independence and longer director tenure, and tended to be a founding-family firm. Second, most admired companies provided their independent directors with higher total compensation mainly in cash and stock compensation. Third, most admired companies' independent-director compensation is made up of a lower percentage of cash and a higher percentage of stock and options than that of their matched companies. This suggests that most admired companies tried harder to align the interest of their independent directors with that of their shareholders by making their directors' pay more sensitive to overall firm performance. These three findings should be useful for other companies that want to emulate most admired companies' corporate governance so as to improve their performance.*

**Keywords**: Corporate Governance, Most Admired Companies, Director Compensation, Ownership Concentration, Female Directors, Board Independence

## *1. Introduction*

This study examines ten corporate governance characteristics of most admired companies and their matched not-admired peers. Such examination is motivated by the finding of Persons (2013) that most admired companies performed financially better than their matched peers during an economically tough time of the 2007-2009 recession. Because corporate governance, mechanisms that induce managers to behave in the best interest of shareholders, can definitely affects a company's performance, it is crucial to find out which corporate governance characteristics differentiate most admired companies from their matched peers, and enable them to outperform their competitors during this longest and worst recession. Any entity can perform well during an expanding economy, but only a company with superior corporate governance could shine through a tough period of the recession. Although the Hay Group, that conducted the survey of "Most Admired Companies" for *Fortune*, has used corporate governance as one of its rating criteria, *Fortune* does not provide any detail about these companies' corporate governance.

An identification of these companies' distinctive corporate governance features during this trying time of 2007-2009 recession can serve as benchmark of best practices for other companies. Corporate governance, particularly issues about board of directors and director compensation has received a great deal of attention from the media and the business community around the world after the major business failures at well-known companies including Enron, WorldCom and Parmalat. This study's findings, which remain virtually the same when the corporate governance data are from a more recent year of 2013, should provide further insight into these issues, and contribute to the literature in corporate governance. None of earlier empirical studies about most admired companies examined their corporate governance.

The paper is organized as follows. The next section discussed the ten corporate governance aspects. This is followed by a section about data collection and research design, results section, and lastly, conclusions section.

## 2. Corporate Governance Aspects

This study examines the following ten aspects of corporate governance during the 2007-2009 recession: board independence, board size, gender diversity of the board, tenure of independent directors, CEO tenure, CEO chairing the board, CEO stock ownership, ownership concentration, whether it is a founding-family firm, and independent-director compensation. Each aspect is discussed below.

### 2.1 Board Independence from Management

A more independent board, comprised mainly of independent outside directors, can perform a better function of decision control and monitoring activities of top managers (Fama, 1980; Jensen, 1993). Rosenstein and Wyatt (1990)'s finding of positive abnormal stock return when outside independent directors were added to boards suggests that stockholders highly value the inclusion of outside independent directors on the board. Beasley (1996) finds that larger proportion of outside independent directors on the board significantly reduces the likelihood of financial statement fraud. Klein (2002) documents less abnormal accruals when the board is more independent from management. More recently, Anderson et al. (2008) find that the cost of debt is inversely related to board independence. Therefore, this study expects most admired companies to have a higher ratio of independent directors to total number of board members than their matched competitors.

### 2.2 Board Size (Total Number of Directors on the Board)

Jensen (1993) argues that a large board is less likely to function effectively and is easier for the CEO to control. Consistent with this view, Beasley (1996) and Dechow et al. (1996) find a positive relation between board size and the likelihood of financial statement fraud. Eisenberg et al. (1998) also finds that larger board size is associated with lower profitability and decreasing firm value. On the other hand, Chaganti et al. (1985) find that chapter 11-bankrupt firms have smaller boards than matched healthy firms, suggesting that a larger board is more effective in preventing corporate failure. Likewise, Beasley and Salterio (2001) finds that firms that voluntarily exceed minimum mandated level of audit committee composition/expertise have larger boards. Because of these conflicting arguments, there is no expectation about board size.

### 2.3 Gender Diversity of the Board

Women often bring a fresh perspective on complex issues, and this can help correct informational biases in strategy formulation and problem solving (Westphal and Milton, 2000). In addition, gender diversity can promote a better understanding of the marketplace by matching the diversity of a firm's directors to the diversity of its potential customers, thereby increasing its ability to penetrate markets (Campbell and Minguez-Vera, 2008). Smith et al. (2006) suggest that a more gender-diverse board may improve a firm's competitive advantage if it improves the firm image, and has a positive effect on customers' behavior and thus on a firm's performance. Female directors may also be better at monitoring function because they might put forward the interests of employees and other stakeholders who have an impact on the company's performance (Kramer et al., 2006). Carter et al. (2003) document a positive relationship between board diversity and firm value, and suggest that women are more inclined to ask questions that would not be asked by male directors, thereby increasing the monitoring effectiveness of the board of directors. Catalyst (2004) finds that firms with better gender diversity achieve better financial performance. It is, therefore, expected that the 50 world's most admired companies have a more gender-diverse board than their matched competitors.

### 2.4 Tenure of Independent Directors

An independent director's lack of seniority on the board will likely have an adverse effect on his/her ability to scrutinize top management.In other words, a more senior independent director is less susceptible to group pressures to conform, and is more likely to raise concern over questionable conduct of the firm. Beasley (1996) finds a negative relation between outside director tenure and the likelihood of financial statement fraud. Persons (2005) reports that the likelihood of fraudulent financial reporting is lower when independent audit committee members have a longer tenure. In addition, the longer tenure of independent directors enables them to develop their monitoring competencies while providing them with firm-specific expertise (Bedard et al., 2004). These studies suggest that tenure increases the outside directors' ability to monitor management effectively, leading to an expectation that the 50 world's most admired companies have independent directors with a longer tenure.

### 2.5 CEO Tenure

A CEO with a longer tenure is more likely to become entrenched and to exercise undue influence over the board (Hill and Phan 1991). Hermalin and Weisbach (1988) also note that an established CEO has relatively more power than a new CEO. On the other hand, a long tenure could mean that a CEO has more of an investment in the firm and the less likely to jeopardize the firm value by engaging in unethical conduct. Daboub et al. (1995) argue that employees with a long tenure are less likely to actively initiate illegal activities. A longer tenure can also enable a CEO to develop firm-specific expertise and strong, stable strategy which is an important element of the world's most admired companies (Colvin, 2009). Because of these conflicting arguments, there is no expectation regarding CEO tenure.

### 2.6 CEO Chairing the Board

Jensen (1993) and Dechow et al. (1996) argue that when the CEO is also the BOD chairman, this top executive could exert undue influence on the board, which is supposed to supervise top management on behalf of the firm's stockholders. The CEO/Chairman could influence the BOD through the process of setting board agenda, managing meetings and controlling the flow of information to the board. These CEOs can also handpick directors who would not seriously challenge them. The idea of separating the CEO and chairman functions is gaining support in the U.S. as indicated by a McKinsey & Co. survey where 70% of directors of Fortune 500 companies favored splitting the two roles, with an estimated one-third of U.S. firms splitting the functions already. Dechow et al. (1996) find that firms manipulating earnings are more likely to have a CEO who simultaneously serves as the board chairman. Persons (2005) also reports that the likelihood of financial statement fraud increases when the CEO also serves as the board chairman. The 50 world's most admired Companies are, therefore, expected to have the CEO who does not chair the BOD.

### 2.7CEO Stock Ownership

There are two opposite schools of thoughts regarding the relation between management stock ownership and firm value. The first one was initiated by Jensen and Meckling (1976) who propose that as management stock ownership increases so does the firm value. This is known as the convergence-of-interest hypothesis because becoming the firm's owner aligns the interest of a manager with that of stockholders. The second one is the managerial entrenchment hypothesis (Stulz, 1988) which suggests that becoming the firm's owner provides the manager with an effective control of the firm, thereby making the manager indulge in nonvalue-added behavior. This second hypothesis suggests a negative relation between managerial ownership and firm value. Griffith (1999) specifically examines CEO ownership and finds that firm value is not a function of managerial ownership when CEO ownership is excluded, indicating that CEO ownership has a dominating effect on firm value. Because of these conflicting arguments, there is no expectation about CEO stock ownership.

### 2.8 Ownership Concentration

A benefit of concentrated ownership is that concentrated shareholders can stimulate or coerce management to work in their interest as they have both an incentive to become involved in governance, and the ability to influence managers by means of direct access strategies and the threat of using their concentrated voting rights (Heugens et al., 2009). Having a wealthy, concentrated owner can also help firms in times of crisis because such owner may choose to transfer private resources into an ailing firm (Heugens et al., 2009). This "propping" phenomenon could help firms improve their performance during recession. These benefits suggest a positive relationship between ownership concentration and firm performance. On the other hand, although these major shareholders have the power to induce management to run the firm in their interests, such interests may diverge from those of minority shareholders resulting in "tunneling" or the transfer of assets and profits out of firms for the benefit of major shareholders (Johnson et al., 2000). Tunneling is especially common in times of economic or financial crisis (Granovetter, 2005). Cheung et al. (2005) and Djankov et al. (2008) provided supporting evidence for tunneling, the negative effect of ownership concentration. Due to these conflicting evidences, no expectation is placed upon ownership concentration.

### 2.9 Founding-Family Firm

A founding family can have a significant influence over important corporate policies, strategy and personnel issues through its stock ownership and/or participation in management. Similar to Anderson and Reeb (2003) and Villalonga and Amit (2006), this study defines a founding-family firm as a firm that has the founder or a member of the founding family as an officer, a director, or an owner of at least 5% of the firm's equity.

According to the agency theory, a benefit of a founding family firm is that the family has strong financial incentive to improve firm performance because they have high equity, and its stake in the firm represents most of the family wealth. Another benefit is that founding-family firms have an effective organizational structure (Anderson and Reeb, 2003). However, a weakness of a founding family firm is that the main purpose of shareholding is more likely to preserve their control rather than investing for capital gain. In this case, a founding-family firm might not pay enough attention to firm performance and may take actions that benefit the family at the expense of other small shareholders (Saito, 2008). Anderson and Reeb (2003), Lee (2004), and Villalonga and Amit (2006) studied founding-family firms in the U.S., and found that family firms performed better financially than nonfamily firms. Maury (2006) showed that in Western Europe, founding-family firms are more profitable than nonfamily firms. On the other hand, studies of U.S. firms by Bennedsen et al. (2007) and Perez-Gonzalez (2006) found that nepotism within a family firm hurts firm performance. Because of the mixed evidence, there is no expectation about whether or not most admired companies are founding-family firms.

### 2.10 Independent Directors' Compensation

Several empirical studies including Becher et al. (2005) and Fich and Shivdasani (2005) indicate that compensating directors with stock options and full-value stock units are associated with higher levels of firm performance. Ertugrul and Hegde (2009) also report that the greater the ratio of outside directors' stock and option compensation to total compensation, the lower the debt-related agency problems (i.e., lower average yield spreads on the firms' outstanding bonds). Between stock options and full-value stock units, full-value stock units seem to be a better way to compensate independent directors because they are associated with better performance or lower debt-related agency problems if the full-value stock units induce directors to adopt a long-term perspective in their monitoring and decision making (Ertugrul and Hegde, 2009 and Khalil et al., 2008). As a result, Magnan et al. (2010) state that the popularity of stock options as an incentive compensation for independent directors has waned, with a full-value stock units emerging as the preferred approach. Based upon these studies' findings, this study expects that: (1) most admired companies compensate their independent directors with more full-value stock units and stock options as a percentage of total director compensation than their matched peers, and (2) most admired companies' total director compensation has a higher percentage of full-value stock units than stock options.

## *3. Data Collection and Methodology*

This study used the rating in *Fortune* article, the World's Most Admired Companies, (Bernasek, 2010) to compare corporate governance of the 50 all-star companies that included 40 U.S. firms and ten foreign firms with another 50 control companies. Although this article was published in March 2010, the survey was conducted in 2009 close to the end of the recession. The reason for using this 2010 ranking is because it is likely that survey subjects considered the company ability to weather the recession from its beginning to its ending in rating these firms as 50 world's most admired companies. Most entities likely do well during a good expanding economy, but only exceptionally managed companies with superior corporate governance could shine through a tough period of the recession. A control company was matched with each of the World's Most Admired Companies on the basis of industry (SIC code) and firm size measured by total assets. This study also tried to match on the basis of home country or geographical region because corporate governance could differ across countries and regions.

This study used the SEC online EDGAR database to collect data on corporate governance and independent-director compensation of the 100 sample firms. These data are from proxy statements (Form def-14a) for U.S. firms and Form 20-F for foreign firms. The data are for the year 2009 only because corporate governance structure stayed about the same across these three years of the recession. Two univariate tests, t-test and Wilcoxon rank-sum test, were used to assess the significance of the difference in corporate governance characteristics between the two groups.

## *4. Results*

Table 1 presents corporate governance characteristics that are significantly different between the two groups based on both t-test and Wilcoxon rank-sum test.

In the order of their significance level, these characteristics are: (1) ownership concentration, (2) whether it is a founding-family firm, (3) a percentage of female directors, (4) the board-of-director independence, and (5) an average tenure of independent directors. Most admired companies tend to have a smaller percentage of their shares owned by block holders, in other words, there is more ownership dispersion among these companies.

Founder involvement in directing/managing the company is also more common among the 50 most admired companies such as Apple, Google, Microsoft, Berkshire Hathaway and Wal-Mart. They also have a higher percentage of female directors. This greater gender diversity at the board level could provide a competitive advantage to most admired companies, and possibly, contribute to their better financial performance reported in Persons (2013). Most admired companies also have higher board independence and a longer average tenure among their independent directors. These two characteristics help strengthen the monitoring effectiveness of their board of directors.

Corporate governance characteristics that did not significantly differ between the two groups are board size, CEO chairing the board, CEO tenure and CEO ownership. Both groups have an average of 12 board members. Sixty percent of most admired companies and 54% of not-admired companies have the same person as CEO and board chairman. An average CEO tenure of both groups is about six to seven years. Most CEOs of both admired and not-admired companies have a very small percentage of stock ownership in their companies, with the median value of less than 0.12%.

Table 2 reports independent-director compensation of most admired companies vs. their matched peers for the year 2009 only because director compensation did not change significantly across the three years of the recession. The compensation is reported in total, and also disintegrated into cash, stock options and full-value stock units as a percentage of total director compensation. Wilcoxon rank-sum test suggests that most admired companies provided their independent directors with higher total compensation. The mean and the median values of the disaggregated compensation clearly show that both groups did not use stock options as much as cash and full-value stock units to compensate their independent directors. A further examination (not reported in the table) reveals that, for both groups, using both cash and full-value stock unit is the most popular approach to compensate independent directors, followed by using cash only. Only 25% of the 100 companies used stock options. These findings are consistent with a recent trend among public corporations to shift away from stock options as a means to compensate independent directors.

The strongest finding about the difference between the two groups in Table 2 is that most admired companies provided their independent directors with a significantly lower percentage of cash compensation than their matched not-admired peers. Another finding supported by t-test only (not Wilcoxon rank-sum test) is that most admired companies provided their independent directors with more stock options and full-value stock units as a percentage of total director compensation than their matched peers. In particular, the mean percentage of full-value stock units is 38.36% for most admired companies vs. 29.68% for not-admired ones, and the mean percentage of stock options is 13.10% for most admired companies vs. 5.97% for not-admired ones. These findings are consistent with the study's expectations that most admired companies compensate their independent directors with more stock options and full-value stock units than their matched peers, and that most admired companies' total director compensation comprises of a higher percentage of full-value stock units than stock options. These results suggest that most admired companies tried harder to align the interest of their independent directors with that of their shareholders (i.e., make the directors' pay more sensitive to firm performance) by using director compensation plans with more emphasis on full-value stock units and, to a lesser extent, stock options.

The study also performed a sensitivity test by using the 2013 data of the ten corporate governance aspects to conduct the analysis. The results based upon 2013 data remain virtually the same as those reported here.

## 5. Conclusions

This study investigated ten corporate governance aspects including independent director compensation of 50 World's most admired companies relative to their matched not-admired firms during the 2007-2009 recession. It reported three significant findings. First, most admired companies had less ownership concentration, tended to be a founding-family firm, had a higher percentage of female directors, higher board independence and longer director tenure. Second, most admired companies provided their independent directors with higher total compensation mainly in cash and stock compensation. Third, they tried to align the interest of their independent directors with that of their shareholders by providing their directors with less cash and more stock and options as a percentage of total compensation than their matched companies. These findings that are not sensitive to changing the sample period should be useful for other companies that want to emulate these companies' corporate governance in order to improve their performance.

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**Table 1: Significantly Different Corporate-Governance Characteristics of Most Admired Companies and Their Matched Peers for the Year 2009**

| Variables | Minimum | Mean | Median | Maximum | T-Test | Wilcoxon |
|---|---|---|---|---|---|---|
| **Ownership Concentration** | | | | | | |
| Admired | 0.00% | 14.83% | 10.75% | 92.61% | | |
| Not-Admired | 0.00% | 30.15% | 23.92% | 98.13% | 3.508*** | 3.956*** |
| **Founding-Family Firm** | | | | | | |
| Admired | 0.00 | 0.34 | 0.00 | 1.00 | | |
| Not-Admired | 0.00 | 0.12 | 0.00 | 1.00 | 2.681*** | 2.601*** |
| **Female Directors** | | | | | | |
| Admired | 0.00% | 18.20% | 19.09% | 35.71% | | |
| Not-Admired | 0.00% | 14.63% | 15.38% | 40.00% | 2.008** | 2.207** |
| **Board Independence** | | | | | | |
| Admired | 0.00% | 78.13% | 83.33% | 93.75% | | |
| Not-Admired | 0.00% | 70.26% | 80.00% | 100.00% | 1.711** | 1.594* |
| **Director Tenure (years)** | | | | | | |
| Admired | 0.00 | 7.24 | 7.21 | 14.65 | | |
| Not-Admired | 0.00 | 6.39 | 6.75 | 15.70 | 1.428* | 1.375* |

*, **, *** Statistically significant at $p< 0.10$, $p< 0.05$, and $p< 0.01$, respectively.

**Table 2: Independent Director Compensation of Most Admired Companies and Their Matched Peers in the Year 2009**

| Variables | Minimum | Mean | Median | Maximum | T-Test | Wilcoxon |
|---|---|---|---|---|---|---|
| **Total Compensation (in thousands)** | | | | | | |
| Admired | 0.00 | 240.88 | 235.00 | 814.00 | | |
| Not-Admired | 0.00 | 221.91 | 210.37 | 1,300.78 | 0.604 | 2.047** |
| **%Cash Compensation** | | | | | | |
| Admired | 0.00% | 46.40% | 41.55% | 100.00% | | |
| Not-Admired | 11.13% | 61.71% | 51.67% | 100.00% | -2.584*** | -2.674*** |
| **%Stock Options** | | | | | | |
| Admired | 0.00% | 13.10% | 0.00% | 92.87% | | |
| Not-Admired | 0.00% | 5.97% | 0.00% | 74.11% | 1.651* | 1.031 |
| **%Full-Value Stock Units** | | | | | | |
| Admired | 0.00% | 38.36% | 45.85% | 100.00% | | |
| Not-Admired | 0.00% | 29.68% | 23.79% | 77.90% | 1.491* | 1.253 |

*, **, *** Statistically significant at $p< 0.10$, $p< 0.05$, and $p< 0.01$, respectively.