JOURNAL OF SMALL BUSINESS STRATEGY

CORPORATE GOVERNANCE IN THE SMALL FIRM: PRESCRIPTIONS FOR CEOS AND DIRECTORS

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ABSTRACT

Examinations of boards of directors of smaller corporations have been largely absent from the academic literature. This study addresses this void by examining several aspects of commonly prescribed board configurations for entrepreneurial (high growth) and small (stable growth) corporations. Specifically, we address board composition and board leadership structure, as well as the impact of officer and director stock holdings and institutional holdings. Stepwise multiple regression analysis reveals that these governance variables significantly add to the explanation of financial performance for both sets of firms. The implications of these findings for Chief Executive Officers (CEOs) and boards of directors are discussed.

INTRODUCTION

Board reform activists have gained considerable attention in recent years due to their promotion of corporate governance reforms. Specifically, these activists continue to pressure corporations to comprise their boards of predominantly outside directors and to adopt the independent board leadership structure (e.g., Geneen, 1984; Kesner, Victor, & Lamont, 1986). Considerable attention has also been focused on increasing officer and director stock holdings as a mechanism for aligning their interests with those of shareholders (Kesner, 1987). Empirical support for these trends, however, is equivocal.

Some of the confusion surrounding recommended board reforms may be the result of an exclusive focus on the largest of U.S. corporations. The potential applications to the smaller corporation are intriguing. Perhaps it is in this domain that the effects of board composition and structure are more readily observed.

An obvious issue implicit in much of this discussion is exactly how much control can any CEO, board chairperson, or board of directors, however configured, bring to bear on the modern corporation. It may be, for example, that CEOs and directors are less constrained by organizational systems and structures in the smaller corporation as compared to those of their larger (e.g., *Fortune 500*) counterparts. It seems sensible that CEOs and directors may be able to more directly influence the processes and outcomes of the smaller corporation. Large corporations are complex with a surfeit of important internal and external constituencies.

...there is an implicit assumption that [management] could initiate shifts in policy or embark on major transition programs for the organization. This assumption may be questionable, **particularly in large organizations**... The sheer number of persons involved, the complexity of the organization, and a variety of vested interests both inside and outside the company represent potential constraints to successful change strategies (Dalton & Kesner, 1983, p. 736, emphasis added).

The following sections present the development of the rationale for adherence to prescribed governance reforms. These include increasing the proportion of outside directors on the board, separating the positions of CEO and board chairperson, and increasing the level of stock holdings for officers and directors. In addition, the impact of institutional holdings on the financial performance of the smaller corporation is addressed.

WHY OUTSIDE DIRECTORS?

Filling the boardroom with a preponderance of outside directors is believed to ensure more active discussion and debate, a greater pool of organizational resources, and more critical assessment of management's performance (Danco & Jonovic, 1981; Mathile, 1988; Nash, 1988). Additionally, outside directors are able to provide expertise and advice to the CEO, resources that are presumably unavailable to the CEO in the current management and staff (Anderson & Anthony, 1986). The preference for outside directors has been noted in the popular press, as well. In an interview with Steven Jacobs of the *Wall Street Journal*, Russell N. Cox, President of Resort Management Inc., echoed the preference for outside directors by rather bluntly noting that the advice of inside directors can be had "any day between nine and five" (Jacobs, 1985, p. 23). Placing inside directors on the board in lieu of outside directors was seen, at best, to be a duplication of efforts adding no value to the firm.

WHAT ABOUT CEO DUALITY?

A related governance issue that has received increasing amounts of attention is the separation of the roles of CEO and board chairperson. Judith Dobrzynski, a *Business Week* senior editor, has been critical of the concentration of power that accompanies the dual structure where "one person rules the roost as chairman and chief executive" (Dobrzynski, 1991, p. 124). Don Hambrick, Columbia University Business School professor, has commented that holding multiple titles is a sign of "power accumulation and power hoarding" (*Fortune*, 1991, p. 13). He has termed this the "Idi Amin phenomenon" after the former Ugandan leader who assigned himself approximately a dozen of the country's top leadership positions. With one individual controlling the management and the board, it is less likely that competing perspectives will be offered for review. Such concentration of power, it is argued, limits the effective functioning of the board.

WHAT ABOUT SHARE HOLDINGS?

The impact of officer and director stock ownership may also affect the financial performance of the firm. Increasing officer and director ownership in the firms they serve may serve to align their interests with those of the shareholders (Chacko, 1990; Johnson, 1990). In the absence of mechanisms that align management and shareholder interests, costly self-interested behaviors such as increasing managements' salaries, adding staff, and managerial shirking are greatly increased (Daily & Dollinger, 1992).

Stock holdings and board composition may provide countervailing effects. Perhaps the distinction between inside and outside directors becomes less salient when the fortunes of corporate officers and directors are tied to the performance of the corporation. Over 200 years ago Adam Smith noted the importance of this financial relationship when he commented that "folly, negligence and profusion" would prevail when directors became the overseers of other people's money rather than their own (Wilson, 1989, p. 68).

WHAT ABOUT INSTITUTIONAL HOLDINGS?

Institutional investors have become increasingly active in the corporate governance reform movement. As evidence, these large-scale investors are actively seeking the replacement of corporate insiders with outside directors who are presumed to provide more objective expertise and counsel. Perhaps the most vocal group has been the California Public Employees' Retirement System (Calpers), the nation's largest public employee pension system (e.g., Foust & Schine, 1990; Kim, 1993). Calpers' CEO, Dale M. Hanson, threatened to oppose the election of directors at such firms as Polaroid, Dial, and Control Data if the firms did not agree to discuss shareholder issues such as board of directors composition and structure. Institutional investors have successfully instituted changes toward outside director representation at Lockheed Corporation and Sears, Roebuck & Co., as well as the separation of the positions of CEO and board chairperson at Sears.

RESEARCH QUESTIONS

Based on the rationale provided in the preceding sections, the following research questions are proposed:

- Do firms with higher proportions of outside directors have higher levels of financial performance?
- Do firms in which the CEO does not serve simultaneously as board chairperson have higher levels f financial performance?
- Are higher levels of stock holdings by officers and directors associated with higher levels of financial performance?
- Are higher levels of institutional holdings associated with higher levels of financial performance?

METHOD

Sample

In order to examine these issues of board composition, CEO duality, and stock holdings, two groups of firms were studied. The first group was selected from the *Inc.* 100 (May 1990 issue). Compared to the Fortune 500, these firms are relatively small. Also, these are high-growth firms that have achieved success in the past five years. The second group was comprised of 183 "small" (i.e., sales of less than $20 million and 500 or fewer employees) corporations listed in *Standard & Poor's Reports: Over-the-Counter and American Stock Exchanges*. All corporations meeting the two selection criteria were included in the second group of firms. As compared to the *Inc.* firms, these are stable, small corporations with modest growth.

Independent Variables

The governance data include the proportion of outside directors and the incidence of CEO duality. These data were collected from *Standard & Poor's Register of Corporations, Directors, and Executives.* We also considered the impact of officer and director stock holdings and institutional holdings. These data were collected from *Standard & Poor's Reports: Over-the-Counter and American Stock Exchanges.*

Dependent Variables

There is considerable debate concerning what constitutes the appropriate set of dependent variables (e.g., Chakravarthy, 1986). In response, Cochran and Wood (1984) suggest the use of measures that capture both accounting and market returns. Consequently, this study relies on widely accepted indices of corporate performance representing both categories: return on assets (accounting measure) and price/earnings ratio (market measure).

Control Variables

It may be that the relationship between selected governance structures and corporate financial performance is not straightforward. The presence of a founder/CEO, for example, may impact the composition and structure of the board (Daily & Dalton, 1993). Founders have been found to have management styles that significantly diverge from those of their successors (Dyer, 1986). These differences may manifest themselves in preferences for governance structures that are not isomorphic with nonfounder CEOs. Size of the firm and the industry in which the firm operates, too, may affect the election of alternative governance structures (e.g., Daily & Dalton, 1993; Dess, Ireland, & Hitt, 1990).

The status of the CEO as founder/nonfounder was provided in the annual survey for the Inc. 100 firms. For the S&P firms, these data were collected via phone calls to the corporate office of each firm. Sales revenue was used as a measure of firm size (Singh, 1986). Industry categories were created based on four-digit Standard Industrial Classification Codes. Five industry categories were included: (1) manufacturing, (2) service, (3) distribution, (4) retail, and (5) miscellaneous. All data are representative of the year 1989.

RESULTS

Table 1 provides the means and standard deviations for the study variables. In order to assess the impact of industry effects, a MANOVA was conducted with the performance variables by industry category. The multivariate test of significance (Wilk's) was not significant for both sets of firms: Inc. ($F=1.34$, ns) and small corporations ($F=1.49$, ns).

Table 1

Descriptive Statistics for Study Variables

Proportion of	*Inc.* 100 Corporations		Small Corporations	
Outside Directors	Mean	s.d.*	Mean	s.d.*
	.56	.21	.59	.19
Dual Structure	.56	.50	.67	.47
Officer/Director Holdings	25.50	19.88	33.72	18.41
Institutional Holdings	12.58	21.27	23.79	12.55
Return on Assets	8.22	12.70	8.43	9.02
Price/Earnings Ratio	.19	.27	.43	.24
Founder Status	.70	.46	.46	.50
Sales Revenues ($000)	88.83	126.40	13.69	5.96

**standard deviation*

Stepwise multiple regression analysis was used to examine the differential benefit of alternative governance structures in entrepreneurial and small corporations. Separate regression models are provided for the *Inc.* firms and the small corporations. This separation allows the examination of whether there are differential benefits to be realized within the more general category of smaller corporations. High growth firms may have very different governance needs as compared to their more stable small corporate counterparts.

To examine the impact of the control variables, these variables were entered as a block in the first step of the stepwise regression. Next, the governance variables were entered as a block in the second step. The results for both sets of firms are consistent. The control variables do not significantly contribute to the performance of smaller corporations. Moreover, the governance variables do significantly add to the explanation of financial performance when relying upon the accounting measure (ROA). The results were not significant for the market measure (price/earnings ratio).

Table 2

Return on Assets (ROA) and Corporate Governance for Small Corporations

	r	r^2	Δ^2	p
Control Variables:				
Founder Sales Revenues	.26	.07	.07	ns
Governance Variables:				
Outside Director Proportion CEO Duality Officer/Director Holdings Institutional Holdings	.44	.19	.12	.014

Table 3

Return on Assets (ROA) and Corporate Governance for Inc. 100 Firms

	r	r^2	Δ^2	p
Control Variables:				
Founder	.22	.05	.05	ns
Sales Revenues				
Governance Variables:				
Outside Director Proportion				
CEO Duality	.55	.30	.25	.01
Officer/Director Holdings				
Institutional Holdings				

Table 4

Price/Earnings Ratio and Corporate Governance for Small Corporations

	r	r^2	Δ^2	p
Control Variables:				
Founder	.19	.04	.04	ns
Sales Revenues				
Governance Variables:				
Outside Director Proportion				
CEO Duality	.37	.14	.10	ns
Officer/Director Holdings				
Institutional Holdings				

Table 5

Price/Earnings Ratio and Corporate Governance for Inc. 100 Firms

	r	r^2	Δ^2	p
Control Variables:				
Founder Sales Revenues	.32	.10	.10	ns
Governance Variables:				
Outside Director Proportion CEO Duality Officer/Director Holdings Institutional Holdings	.39	.15	.05	ns

DISCUSSION

These results provide some demonstration of the impact of corporate governance on financial performance in smaller corporations. The authors must conclude, however, that widescale prescriptions for altering boards of directors based upon empirically unsubstantiated prescriptions are ill-advised. The information suggests that firms with **lower** proportions of outside directors outperform their counterparts with greater representation by outside directors. This is true for both the small corporations as well as the *Inc.* 100. This is notable as it is opposite from what might have been expected relying on the admonitions of many organizational observers.

The results from the CEO duality question are in the expected direction. For both groups of corporations, higher levels of financial performance are associated with firms that have different persons serving as CEO and chairperson of the board. Share holdings of officers and directors, as well as institutions, are also in the anticipated direction. Higher levels of holdings by these groups are associated with higher levels of financial performance. Contrary to the findings for board composition, prescriptions designed to separate the CEO and board chairperson and increasing the share holdings of officers and directors and institutions seem well placed.

The authors suggest, however, that few organizational observers would be comfortable recommending that board reapportionment alone would resolve the dilemma surrounding corporate accountability and the board of directors. Rather, based upon the examination of smaller corporations, the authors suggest that the distinction of outside director provides a logical and readily identifiable starting point for that difficult task of identifying those individuals who might best serve their directoral duties of service, resource acquisition, and control (Zahra & Pearce, 1989).

DIRECTORS AND THEIR ROLES

Service Role

The findings of this study indicate no financial benefit to a preponderance of outside directors in the small or entrepreneurial corporation. It may be that CEOs are actively seeking the advice and counsel of their inside directors and that these management directors are responding to these requests. The ready access to these individuals provides the CEO with a cadre of advisors who are both knowledgeable and available on a regular basis. Outside directors may be less able to remain fully informed about the intricate details of the firms they serve and are certainly not as accessible to most CEOs as are inside directors.

Resource Acquisition Role

Inside directors appear to be as able, if not more able, than their outside director counterparts to garner resources and/or expertise from the external operating environment. Again, it may be that inside directors have an edge due to their specific knowledge of the firm's needs and capabilities. Linking the corporation with critical external constituents may be easier for those directors who have daily contact with the organization. Knowing when to seek help is as important as knowing who to contact for help.

Control Role

The control role of directors—monitoring management for the benefit of its shareholders and other constituencies—may be the most critical board function. In fact, prescriptions based upon the inside/outside director distinction may best address concerns regarding the board's ability to effectively monitor the management of the corporation. Outside directors are arguably the only reasonable candidates to fulfill this role. It would be unreasonable to expect that the very individuals beholden to the CEO for their positions would treat this individual harshly, yet alone seek to involuntarily replace this individual. If outside directors do provide the corporation with "an edge," it would be most salient when considering the control function of directors.

THE ADVISORY BOARD

These findings regarding the role of outside directors may be welcome news for many small firm owner/managers. Often, the very size of the firm places resource constraints on the ability to secure an active board of directors. Reliance upon current management to fill board seats may be a necessity. A significant number of small corporations may be unable to afford the average retainer of $7,000/year per board member (Nash, 1988).

One means for overcoming this barrier is the use of an advisory board. *Inc.* magazine recently chronicled the experience of one owner/manager as she utilized the services of an ad-hoc board of directors for one year (Brittina, 1993). Powerlink, a nonprofit organization, awarded Anita Brittina and one other female entrepreneur the board for one year as a means to help them strengthen and grow their firms. This experience has not been without its difficulties (e.g., directors failing to attend meetings), but the benefits of this cost-free advice have been numerous. Brittina's experience serves as one example of a mechanism for small firm owner/mangers to garner the benefits of the formal board, without the cost.

SEPARATE IS EFFECTIVE

The findings in this study caution against reliance on the dual leadership structure. The political arena provides a nice corollary to the business environment in this circumstance (Kesner & Dalton, 1986). The authors believe, for example, that most political observers would be concerned if the offices of the President of the United States and the Chief Justice of the Supreme Court were held by the same individual. This would violate any remote notion of some "separation of powers." Perhaps more distance between the judiciary and the executive branch would lead to a somewhat objective outcome.

Certainly, the authors do not suggest that the modern board of directors is the corporate equivalent of the Supreme Court. Still, a large part of the charter of the board is to monitor and control the CEO. While the mission of the board is much broader than this, it clearly includes this function. Perhaps, then, some thought should be given to the structure of the CEO and board chairperson role. The structural separation of these two powerful positions may engender some degree of confidence in the effectiveness of the board and the willingness of corporate management to serve the overseers of stockholders' wealth.

OWNERSHIP COUNTS

The increasing trend toward compensation systems that rewards officers and directors with ownership shares of the firms they serve seems to be beneficial. The obvious goal of these programs is to encourage those entrusted with the long-term health of the organization to think like owners. Based upon our study, this intent appears to be realized. Higher levels of stock ownership were associated with higher levels of firm financial performance. The implications of these findings are clear: Increasing officers' and directors' financial stakes may increase their interest in responsibly attending to the financial health of the corporation. Owners apparently think and act like owners.

The levels of stock holdings found in this study should please some critics of the modern corporation. T. Boone Pickens, for example, stated that the "absence of financial risk is inconsistent with the free-enterprise system" (Chacko, 1990, p. 75). It is not unusual for CEOs, high-ranking officers, and board members to own little stock in companies they serve. Absent this linkage, it is the shareholder who endures the decline in equity value. By virtue of more intensive financial relationships, officers and directors may have a greater ability to relate to and act like shareholders. A certain irony may be noted, however. When directors become major shareholders in the corporations they serve, the notion of "outside" direction may be lost. In general, one could hardly expect a director with a large equity stake in the firm to be a dispassionate observer. The objectivity that is deemed so critical may be sacrificed for a focus on short-term gains in stock price.

The impact of institutional investors is positive as well. Perhaps the lack of "independence" caused by a reliance on inside directors is overcome when a powerful outside monitoring body is present. Institutional investors may serve as a catalyst for keeping the smaller firm directed toward maximizing shareholder wealth.

PRESCRIPTIONS FOR CHIEF EXECUTIVE OFFICERS AND DIRECTORS

The authors hesitate to suggest that there exists any one governance configuration appropriate for the smaller corporation. This study does, however, provide some guidance as to those elements that may enhance the financial performance of these firms. Adherence to the commonly prescribed outsider-dominated board may be unnecessary, and even harmful, for the smaller corporation. The results of this study indicate that it is the insider-dominated board that is associated with increased financial performance.

Another common prescription, separation of the positions of CEO and board chairperson, does seem well-advised. The authors find that adherence to the separate structure is also associated with firm financial performance. The separation of these positions ensures the presence of a board member conversant in firm affairs whom the CEO may rely on for advice and counsel. The separate board chairperson position also provides for some level of managerial monitoring. Additionally, we would note that the independent board leadership structure has implications for the composition of the board. This separation almost certainly guarantees at least one independent director, as it would be unlikely that a subordinate to the CEO (inside director) would be placed in this position of authority.

Officer and directors stock holdings, too, have implications for the financial performance of the small corporation. Not only do stock holdings help align insiders' interests with those of the shareholders, they may also provide the organization a means to attract outside talent for board service. While outside directors would not be compensated on the basis of an annual retainer as is traditionally the case, they would have an increased incentive to actively serve the small firm. Brittina (1993) has recently noted the difficulty of gaining and retaining the interest of small firm directors.

DIRECTIONS FOR FUTURE RESEARCH

This study suggests the need for a finer distinction between classes of directors. Past examinations of board composition have focused largely on the independence of the outside director. Perhaps for the smaller firm this is less a concern than is the quality of advice and counsel provided to the CEO. It may be reasonably argued that inside directors' day-to-day experience with the smaller firm provides them with the requisite firm-specific knowledge necessary to responsibly contribute as a board member. Outside directors, whether paid or advisory, may lack the incentive of insiders to consistently attend to the special needs of the smaller firm (e.g., Brittina, 1993).

Greater attention to the financial stakes of officers and directors of the smaller firm is also warranted. These findings suggest that stock holdings may serve to align the interests of officers and directors with those of shareholders. Granting outside directors stock options in the small or growing firm may provide one means for generating active participation from outside directors with little to no initial cash outlay. In this manner, the firm gains from the expertise and resources that the outside directors may provide and the outside director has some incentive for providing high quality assistance to augment the value of the stock options.

Additional attention to the role of institutional investors in the small corporation would seem appropriate. Past research has focused exclusively on the role of institutional investors in the large firm. While the level of institutional holdings for this study was something on the order of one-fourth the magnitude found in large firms (e.g., *Business Week*, 1984), these levels are likely to continue to increase. Institutions may provide the level of control needed to keep management focused on the long-term and interested in the welfare of shareholders.

CONCLUSION

Frankly, the authors find the suggestion that today's boards are not competent to discharge their directoral duties is grossly overstated. Moreover, inside directors appear to be responsibly meeting the dual demands of acting as caretaker for the long-term health of the corporation, as well as addressing their operational duties as managers. Rather than focus on the distinction between inside and outside directors, corporate participants and observers might focus their attention on the leadership of the board and financial incentive packages for directors. With respect to the financial performance of the corporation, it is these two aspects of the board that appear to be most significant.

Boards now—perhaps more than ever—are becoming more focused in their role, more attentive, and more assertive. Recent events at General Motors, IBM, and American Express may underscore this contention. Whatever else may be said about the structure of boards and CEOs' roles, the ultimate responsibility for effectively discharging the many missions of the board resides with individual directors. With the great privilege of being a director comes a commensurately large responsibility. Whether directors are "inside" or "outside" matters less than their attention to the long term objectives of the corporation and those of its multiple constituencies.

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