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CEO DUALITY AND BOARD INDEPENDENCE

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This study looked into the relationship between CEO (Chief Executive Officer) duality and board independence measured in terms of the percentage of outside directors. Results from a sample of 65 records of companies listed in the Philippine Stock Exchange showed that there is a positive relationship between CEO duality and board independence, which is contrary to expectations of the agency theory. However, when the interaction of board independence and industry was introduced, the main effect of board independence disappeared even as the interaction effect was significant and in the positive direction. The result suggests that the effect of board independence cannot be taken separately from industry dynamics. In addition, the null result of the interaction effect of board independence and organizational age suggests that tradition negates the relationship between board independence and duality.

I. INTRODUCTION

In modern corporations, the board of directors represents the shareholders. Board of directors are responsible for setting corporate direction and ensuring corporate performance even as they monitor the conformance of company executives to the policies and programs they have laid down (Collis and Montgomery, 1998; Tricker, 1994). Though the ultimate responsibility for company performance lies with the CEO, starting with the establishment of purpose translated into strategies and implementing such by providing leadership and creating an ethical as well as a challenging work environment, the board is still accountable to the shareholders for maximizing returns on their investments (Collis and Montgomery, 1998). While the board monitors the CEO and may fire him in cases of poor performance, this role of the board is often challenged when the board chairman is the CEO as well. Still, CEO duality abounds in the Philippines.

This paper looks into the relationship between board independence and CEO duality. The study is informed by two perspectives. Duality and the issue of corporate governance in general are commonly viewed from the perspective of agency theory (Conyon and Peck, 1998; Sanders and Carpenter, 1998; Beatty and Zajac, 1994). However, in addition to agency theory, this paper uses institutional theory in explaining CEO duality. The two theories, taken together, one anchored on the assumption that organizations adopt structures that maximize efficiency and another based on the assumption that organizations adopt structures that increase legitimacy regardless of efficiency concerns, provide additional insight into the nature of duality (Palmer, Jennings and Zhou, 1993; Gooderham, Nordhaug, and Ringdal, 1999).

From the agency theory perspective, the board of directors protects shareholders from top management actions that are not congruent with their interests. Such problems arise because of the separation of ownership of the firm from its management (Fama and Jensen, 1983). But by separating the control of decisions (ratifying and monitoring) from its management (initiating and implementation) agency problems may be mitigated (Fama and Jensen, 1983). On the other hand, critics advance that separating the

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positions of chairman of the board and CEO weakens the CEO's authority and dampens his entrepreneurial spirit, which is critical to a company's survival (Collis and Montgomery, 1998). The presence of dual and non-dual CEOs tells us that perhaps there may be conditions that make for the existence of duality.

Another perspective that may shed light on CEO duality is institutional theory. From this perspective, organizations are seen as operating in a social network of relationships. As such, the organization adopts a governance arrangement that does not necessarily maximize efficiency but rather, increases legitimacy (Palmer, et al., 1993). When an organization becomes accepted in its network, it gains legitimacy, which increases its chances for survival (DiMaggio and Powell, 1983). One of the ways in which legitimacy is gained is through isomorphism, the organization's resemblance to others in its environment. It is also advanced that isomorphism increases legitimacy (Deephouse, 1996; DiMaggio and Powell, 1983). DiMaggio and Powell (1983) stated that isomorphism may result from three pressures: coercive pressures which result from political factors or government mandate, mimetic changes which are an organization's response to uncertainty, and normative pressures arising from professionalism and social networks. In addition, legitimated arrangements may be perpetuated through tradition, which may be exemplified by the founding members of the network (Palmer, et al., 1993). Thus, from this perspective, CEO duality may be a function of an organization's effort to gain legitimacy, as it resembles other organizations in its field.

II. IMPACT OF DUALITY

Numerous studies have looked into the influence of duality on other variables. CEO duality was found to influence CEO succession (Cannella and Shen, 2001) and board selection (Westphal and Zajac, 1995; Zajac and Westphal, 1996a,b) two important decisions that significantly impact on managerial entrenchment. Cannella and Shen (2001) reported that when CEO power is high, there is reluctance on the part of the CEO to relinquish power such that there is a lower tendency for an heir apparent to be promoted. In the case of selection of board of directors, Westphal and Zajac (1995) reported that CEO duality was positively associated with demographic similarity between CEO and new directors. However, the separation of CEO and board chairman positions was positively associated with demographic similarity between existing board members and new directors. In a related study, Zajac and Westphal (1996b) reported that in organizations where CEO duality existed, change in CEO age, as well as functional and educational backgrounds was less likely when succession occurred. Further, it was found that when there was a separation of the CEO and board chairman positions there was an increased CEO-board similarity in terms of age, and functional and educational backgrounds. Thus the above studies suggest that CEO duality determined whether an heir apparent was going to be promoted and whether successors would have similar characteristics with the existing CEO.

Director reputation also influences board selection (Zajac and Westphal, 1996a). Top managers maintain control by selecting board members who had experienced being in passive boards. More specifically, a director's participation in separating CEO and board chair positions is negatively related with appointments to boards that have low control over management, while participation in combining CEO and board chairman positions is negatively related with appointments to boards with high control over management (Zajac and Westphal, 1996a). Poor performance is often a precursor of active participation of the board (Johnson, Hoskisson, and Hitt, 1993). And when poor performance leads to dismissal, it is more likely that the successor is an outsider, but CEO duality does not moderate the relationship between performance and outsider selection (Cannella and Lubatkin, 1993).

However, in a study of top management pay in the United Kingdom, Conyon and Peck (1998) reported that CEO duality was not associated with top management compensation. In addition, Sanders and Carpenter (1998) reported that the interaction of CEO duality and degree of internationalization was negatively related to compensation, which was contrary to their hypothesis.

It appears from the results of the foregoing studies that while CEO duality was a relatively consistent factor in explaining managerial entrenchment through its effect on CEO succession and board selection, its effect on compensation was not clearly established. Meanwhile, Westphal (1998) advanced that greater board independence may not necessarily imply greater power to protect shareholder interests. Invoking psychological reactance theory, he reported that changes in board structure resulting in an increase in the board's independence from management tend to increase ingratiation and persuasion behavior toward board members, thereby negating the effect of such independence on corporate strategy and compensation. Thus, while agency theory did not provide a direct explanation of the relationship between increased board independence and strategy and compensation, reactance theory offered a plausible explanation of such null result.

III. REVIEW OF FACTORS EXPLAINING DUALITY

There are several studies on the effect of duality on important decisions such as succession and compensation; however, only a few deal with factors influencing duality. Sanders and Carpenter (1998) combined information processing and agency theories to predict the impact of internationalization on governance structure. They argued that the complexity introduced by internationalization increases information asymmetry, which reinforces the agency problem. In addition, the inherent ambiguity of cause-effect relationships in international management situations called for greater agent discretion, thus increasing the agency problem. Their results showed that internationalization was significant in predicting CEO duality. On the other hand, it appears that the relationship between CEO duality and vigilant boards expressed in terms of greater outsider ratio is more complex than it seems. Sans control variables, CEO duality was positively associated with board vigilance, which did not support agency theory (Finkelstein and D'Aveni, 1994). However, when informal CEO power was taken into account, its interaction with board vigilance was now negatively associated with duality.

The above review of literature shows that several studies have been made on the impact of duality, for example on compensation (Conyon and Peck, 1998; Sanders and Carpenter, 1998), board succession (Cannella and Shen, 2001), board selection (Westphal and Zajac, 1995; Zajac and Westphal, 1996a,b). But fewer studies have been done on the factors that explain duality. This is the research gap this study wants to address; however, the relationship of central concern is that between CEO duality and board independence.

IV. HYPOTHESES

The issue of corporate governance seen from the perspective of agency theory is focused on mitigating the agency problem by separating control of decisions from its management (Fama and Jensen, 1983). The concerns of studies using this perspective are on managerial entrenchment and enrichment (Collis and Montgomery, 1998). Duality offers the CEO a considerable power over the board, which is supposed to monitor the CEO's performance, in terms of controlling the agenda and information exchange during board meetings (Finkelstein, and D' Aveni, 1994). Boards with a considerable number of outside directors tended to maintain the needed power to enforce their monitoring role (Kosnik, 1990; Tosi and Gomez-Mejia, 1989). Thus from the agency theory perspective:

H1. Board independence is negatively associated with CEO duality.

From the institutional theory perspective, adopting a dual CEO arrangement is a response to pressures to increase legitimacy rather than a rational choice to increase efficiency. While several institutional processes may account for the adoption of duality, this paper focuses on the normative and mimetic pressures transmitted through social networks (Scott, 1988; Palmer, et al., 1993) and tradition (Palmer, et al., 1993). Organizations within an industry share social networks, which may take the form of professional organizations or industry associations.

Integrating perspectives from agency and institutional theories, leads to the argument that certain industry realities act to moderate the effect of board independence thus:

H2. The relationship between board independence and duality is moderated by industry.

On the other hand, practices may be handed down through tradition. It appears that reforms on governance became more pronounced only in the 1990s. The Cadbury report of 1992 for instance recommended the separation of the positions of CEO and chairman of the board. This implies that traditionally, organizations were adopting a dual CEO arrangement. Because of this, the impact of board independence on duality may be negated by the organization's age. Thus:

H3. There is no relationship between the interaction of organization age with board independence and duality.

V. SAMPLE

The sample consists of 65 organizations listed in Corporate Handbook, which contains companies listed in the Philippine Stock Exchange.[1] This number was determined using a significance level of 5 percent and a margin of error of 10 percent. Inasmuch as the estimated sample size is greater than five percent of the number of companies listed in the handbook, a finite population correction factor was applied. The 65 companies were chosen using systematic sampling with random start.

VII. VARIABLES

The dependent variable in this study is CEO duality which is a binary variable coded 1 when the CEO is also the chairman of the board and zero otherwise.

This study has three independent variables: board independence, the interaction between company age and board independence and the interaction between industry sector and board independence. In agency theory, the board is considered as a monitoring mechanism (Fama and Jensen, 1983; Vance, 1983). Independent directors are more likely to protect their reputation as directors, thus the drive to be more active in monitoring the CEO (Fama and Jensen, 1983). To maintain continuity and comparability of results (Beatty and Zajac, 1994; Finkelstein and D' Aveni, 1994; Westphal, 1998) board independence is measured by the ratio of outsider board members to total number of board of directors.

Company age and industry are two institutional theory variables of interest in this study. Two independent variables were formed by the interaction of board independence and each of these two institutional theory variables. The proliferation of structures can result from emulating those used by pioneers in the field because such popularity of organizational form among pioneers may be construed as being the appropriate structure (Stinchcombe, 1965 in Palmer, Jennings, and Zhou, 1993). This idea may be extended to the emulation of governance structure as well. Tradition is captured by company age which in turn was computed as the number of years between its founding and 2001. Similarly, the proliferation of an organizational form may come about by emulating current forms (DiMaggio and Powell, 1983). Again, this idea may be extended to the emulation of governance structure as well. The popularity of a governance structure in the field may be an indication of its appropriateness (Palmer, Jennings, and Zhou, 1993). Industry was used to capture this mimetic pressure. Industry was a categorical variable. The organization is coded 1 when it is included in the NEDA (National Economic and Development Authority) classification of service sector such as transportation, communication, storage, trade, finance real estate, government and private services, and 0 when it is engaged in such industries as mining, quarrying, manufacturing, construction, electricity, gas and water—the categories of activities labeled by NEDA under the industry sector. The sample did not contain organizations belonging to the primary sectors, i.e., those engaged in agriculture, fishery and forestry.

In order to capture the effects of variables thought to affect either dependent or independent variables, these are introduced as control variables. In this study, performance is used as a control variable. This is measured as the average return on assets from 1999 to 2001. This measure captures returns controlling for size of the organization represented by assets. Industry sector and company age are also introduced as control variables.

VII. RESULTS

The sample consisted of 65 companies listed in the Philippine Stock Exchange, 78.5 percent of which belonged to the services sector. The average age of the organizations in the sample was 33.72 years, however, return on assets averaged over three years from 1999-2001 was -.42. While the percentage of outsider directors averaged 69.79 percent, some 43.1 percent of the sample organizations have combined the positions of the CEO and chairman of the board. Table 1 shows the means, standard deviations and correlations of selected variables.

Table 2 contains the results of logistic regression analyses on duality. Model 1 contains the regression on duality without the interaction terms. Hypothesis 1 predicts that board independence (represented by proportion of outside directors) is negatively associated with duality. However, the coefficient of board independence is positive and significant with $p<.05$. While this result is contrary to the prediction of agency theory, Finkelstein and D' Aveni, (1994) found a similar positive relationship between their measure of board independence and CEO duality.

The interaction of the agency theory variable, percentage of outside directors, and industry as well as its interaction with organization age were added in Model 2. The results show that while the coefficient of percentage of outside directors was now negative, consistent with the prediction of agency theory, it did not come out significant.

Hypothesis 2 predicts that the relationship between board independence and duality is moderated by industry. The coefficient of this interaction term is marginally significant with $p<.10$. This result implies that to some degree, mimetic and normative pressures moderated the relationship between board independence and CEO duality.

Hypothesis 3 predicts that there is no relationship between duality and the interaction of board independence and organization age. The coefficient of this interaction term is not significant, which supports hypothesis 3.

All control variables, organization age, industry sector and return on assets are not significant.

VIII. CONCLUSIONS

This study explored the relationship between CEO duality and board independence using two perspectives. From the agency theory, it is advanced that board independence is negatively related with duality. From the perspective of institutional theory, it is expected that organization age is positively related with duality and that duality is associated with industry. By integrating the perspectives of agency and institutional theories, it is advanced that the relationship between board independence and duality changes.

The study presented interesting findings. Without the interaction terms, board independence was positively associated with duality, which is contradictory to agency theory prediction. However, this result is consistent with the positive association between board vigilance and duality obtained by Finkelstein and D' Aveni (1994). A plausible explanation of the contradictory result is that CEO entrenchment through CEO duality becomes less of a concern when there is a critical mass of independent directors. On the other hand, it is argued (Dharwadkar, George, and Brandes, 2002) that the solutions to agency problem advanced by the agency theory, which may be effective in developed economies characterized by a strong governance context, may not necessarily work in a context of weak governance, which Philippine companies are operating in.

Another finding of this study is that by itself, institutional theory is limited in explaining duality but it does enrich our understanding of the relationship between board independence and duality. Although marginally significant, normative pressures tend to influence governance structure. The positive relationship between board independence and duality is more pronounced in the service sector. This implies that board independence cannot be treated separately from the industry variable. In addition, the null result of the interaction term between board independence and organization age provides some evidence that tradition negates the relationship between board independence and duality.

IX. DIRECTIONS FOR FUTURE RESEARCH

This study has shown that the relationship between board independence and duality is more complex than it seems. Following agency theory, the result of this study suggests two things: the need to further refine the measure of board independence, and the need to do a comparative study of the relationship between board independence and CEO duality in weak as well as strong governance contexts. Assuming agency theory holds, the result implies that a high ratio of outside board members does not necessarily imply board independence. However, the use of published data posed some limitations to measuring board independence in terms of percentage of outside directors. The results suggest that some qualifications need to be in order to ascertain the independence of the board. For example, the tenure of outside directors may be compared to that of the CEO, which requires data beyond those currently published. The latter direction for future research—introducing governance context—will lead to the refinement of the agency theory. The idea earlier expressed that CEO entrenchment through CEO duality becomes less of a concern when there is a critical mass of independent directors, may also be pursued. This may also lead to the refinement of the agency theory.

In addition, studies have been done on the relationship between performance and CEO duality. This is one area that may be explored in the Philippine setting in order to ascertain the appropriate board structure.

NOTE

[1]Sample size was obtained using the formula (Roberto, 1987): $N = z^2p(1\text{-}p)/MOE^2$ where: n = required sample size; z = value under the normal curve corresponding to the confidence level desired, in this case, five percent (subjective); p = proportion being estimated. P= .5 was used in order to capture the most variability —p(1-p); MOE = margin of error or precision is the desired range the population proportion will fall, in this case ten percent (subjective). The sample size obtained using the formula is 96.

The above formula assumes an infinite population. Inasmuch as the estimated sample size is greater than five percent of the population of corporations listed in the Corporate Handbook, which is 233, a finite population correction factor was introduced: $N = n_0/[1+ (n_0 -1)/N]$: where n_0 = sample size without the correction factor; N =population size. The handbook listed 233 companies. However, eight companies were newly listed (second half of 2001) and another 25 had not submitted their 2001 reports. These companies were excluded from the universe. Thus, n = 65.

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Table 1: Means, Standard Deviations and Correlations of Selected Variables

Variable	Mean	Standard Deviation	N	Correlation		
				Age of Organization	Percentage Outside Directors	*Return on Assets
Age of Organization	33.72	22.67	65	1.000		
Percentage of Outside Directors	69.79	16.05	65	.102	1.000	
*Return on Assets	-.42	12.67	63	-.08	.02	1.00

*Three-year average from 1999 to 2001

Table 2: Logistic Regression Analyses of Duality

Variables	Model 1	Model 2
Percentage of outside directors	.047*	-.067
Average ROA	-.006	-.006
Age of organization	.004	-.076
Industry	.97	-5.859
Interaction of percentage of outside directors and age of organization		.001
Interaction of percentage of outside directors and industry		.099⁺
Constant	-4.623**	3.198
Model Chi-Square	8.571⁺	13.092*
Percentage Classification	71.4	76.2

⁺p<.10 * p<.05 **p<.01