

The Finance Committee of the Board and Financial Performance: A Resource Dependence Perspective

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This study examines whether properly staffed board-level finance committees improve firm performance. Using a sample of US firms, directors are categorized using resource dependence taxonomy. Hypotheses related to firm performance are formulated and metrics including accounting measures, stock market performance, and long-term investments tested. There is some support that firms with a finance committee showed greater Jensen productivity measures. The evidence also suggests that finance committees are most effective in improving performance when staffed with top management from publicly traded companies and investment or commercial bankers. Consistent with others, we find little association between firm performance and overall board composition.

A common question that arises in studies of corporate governance focuses on the relation between board composition and firm performance, particularly whether the presence of outside, independent directors improves the financial metrics upon which investors make decisions. Agency theory (Fama, 1980; Jensen & Meckling, 1976) provides theoretical support that independent board members should be better at monitoring management than management-directors themselves, thus forcing management to maximize shareholder wealth rather than managers' own utility. According to John Biggs, CEO and chairman of TIAA-CREF (Biggs, 1995), more effective control should result in better firm performance. However, most studies find little or no correlation between board composition and various measures of performance (Baysinger & Butler, 1985; Bhagat & Black, 1999; Dalton, Daily, Certo & Roengpitya, 2003; Dalton, Daily, Ellstrand & Johnson, 1998; Hermalin & Weisbach, 1991; Mehran, 1995).

Much of the board literature has focused upon the oversight function whereby directors ratify management decisions and monitor their implementation (Baysinger & Butler, 1985; Baysinger & Hoskisson, 1990; Daily & Dalton, 1992; Fama & Jensen, 1983). Board responsibilities also include hiring, advising and/or terminating the CEO (Lorsch & MacIver, 1989; Warner, Watts & Wruck, 1988; Weisbach, 1988), acting as an important link to information and resources (Pfeffer, 1972; Pfeffer & Salancik, 1978; Zald, 1969), and assisting the CEO in the development of a strategic plan (Harrison, 1987; Nicholson & Kiel, 2004; Zahra & Pearce, 1989). It may be that the insiders, outsiders or affiliates classification method employed in the agency literature is useful for examining separation of ownership and control, but determining whether outside board members contribute strategically requires other approaches (Hillman, Cannella & Paetzold, 2002; Peng, 2004).

Pfeffer (1973) and Pfeffer and Salancik (1978) proffer a resource dependence perspective that directors are a resource used to allay environmental uncertainty, either when acting as counsel to provide information from insights based upon specialized knowledge and experience or when helping to acquire critical resources via their ties to other firms and stakeholders. In comparison to agency theory, empirical evidence to date suggests resource dependence theory “is a more successful lens” (Hillman, Withers & Collins, 2009, p. 1408) for understanding boards, and Peng (2004) suggests resource dependence theory may be particularly useful in examining the relationship between outside directors and firm performance.

In order to oversee the firm’s long-term investment strategy (Fama & Jensen, 1983; Zahra & Pearce, 1989), many boards have voluntarily established finance committees to assist them in discharging their responsibility for financial strategy and capital investments (Anderson & Anthony, 1986; Klein, 1998). Committees, in doing their work, meet separately and make recommendations for approval by the full board. Thus, meaningful policy input comes most frequently from the relevant committees’ members, rather than from board members who are not on the committee (Anderson & Anthony, 1986; Braiotta & Sommer, 1987). One might surmise that value-maximizing firms will staff finance committees either with insiders, who possess an employee perspective on the firm as Klein (1998) asserts, or with board members possessing financial expertise, experience and/or connections to the financial community. Therefore, examining whether finance committees, and the directors thereon, add value from the resource dependence perspective provides an important extension to the literature.

In this paper, we examine questions related to the composition and efficacy of corporate boards’ finance committees as related to firm performance using a sample of large United States firms. Specifically, we develop and test hypotheses related to whether the existence of a finance committee is associated with firm performance and whether the composition of the finance committee, categorized from a resource-dependence perspective, adds value. This study extends Klein’s (1998) prior work by examining a post-Sarbanes Oxley sample and by refining the measures of director backgrounds to include resource-dependence roles.

COMMITTEES OF THE BOARD

Committees provide the means, opportunity and structure that enable members to perform their fiduciary and other corporate governance duties as well as satisfy public demand for increased corporate accountability. Lorsch and MacIver (1989) argue that committees enable directors to better use their time when dealing with complex information. “Through these committees board members may probe into important areas of corporate concern more deeply than would be possible in a full board meeting” (Harold M. Williams, President & CEO, J. Paul Getty Trust [former chairman, Securities and Exchange Commission; former dean, Graduate School of Management, University of California at Los Angeles], in Braiotta & Sommer, 1987, p. xi – xii). Committees are also where much of the board’s work is, or should be, done (Anderson & Anthony, 1986).

There are two general types of committees (Braiotta & Sommer, 1987; Harrison, 1987). The audit, compensation and nominating committees, traditionally staffed with independent outsiders, comprise the first type. The principal reason for their existence is monitoring or control. The other group, the so-called management support or operating committees, provides advice to management and the board and, more specifically, include finance and executive committees. Membership generally consists of a mixture of insiders and outsiders (Harrison, 1987).

Klein (1998) argues that directors add value depending upon committee assignment and that committee membership acts as proxy for their duties on the board. Her intuition is insiders possess the specialized expertise and accumulated in-house experience necessary to evaluate and to ratify the firm’s long-term investment strategies, thus will be selected to serve on finance committees, whereas outside directors make better monitors and can more positively affect firm performance by sitting on audit or compensation committees. Her results show a significant and positive association between the percentage of inside directors on finance and investment committees and accounting and stock market measures even though she reports no significant relation between the percentage of insiders and firm performance as a

whole, and she shows no significant relation between the existence of a board level finance committee and firm performance.

Two extensions of Klein's work are pertinent to this study. First, she uses an agency theoretic approach to classify directors as insiders or outsiders/affiliates instead of a resource dependence approach which may provide new insights. Second, her work predates important legislation leading to boards and, by extension, committees predominantly staffed by outside board members. Following passage of the Public Company Accounting Reform and Investor Protection Act of 2002 (Sarbanes Oxley), U.S. stock markets added rules pertaining to director independence and committee structure for publicly-traded companies. For companies traded on the New York Stock Exchange and the NASDAQ, listed companies must have a majority of independent directors. In other words, boards should be composed primarily of members or outsiders without personal, professional or familial ties to the corporation and its suppliers or affiliates of management. Moreover, nominating/corporate governance, compensation and audit committees must be composed entirely of independent directors (NASDAQ, 2003; NYSE, 2003), although NYSE Section 303A Corporate Governance Rules gave listed companies until their first annual meeting after June 30, 2005, to replace a director who would not be considered independent under proposed revisions to an "immediate family member" test in δ 303A.02(b)(iii).

It is not required that firms have a finance committee, nor are there any requirements related to staffing such a committee. That leads to the first of two hypotheses. First, a wealth-maximizing firm should have a finance committee only if it improves firm performance. Thus,

H1: The existence of a board-level finance committee has a positive impact on the firm's financial performance.

Second, the agency theory on which Klein (1998) bases her arguments suggests a strong management presence on finance committees. However, post-Sarbanes Oxley boards are increasingly staffed with outside members. Outside directors should be appointed to the finance committee only if they add value, as the committee itself and outsiders' presence on the committee are both optional. If committee assignment provides insight into the directors' role, and directors are elected because of their human capital and relational capital as resource dependence theory asserts, then finance committees should be staffed by members either known for their business/financial acumen (i.e., human capital) or their connections to the investment community (i.e., relational capital). The second hypothesis tests the likelihood of employee-directors vis-à-vis the resource dependence composition of the other board members comprising the finance committee. Hypothesis two states:

H2: There is a stronger likelihood that the membership of the finance committee will consist of outsiders known to possess financial expertise or connections rather than insiders with their more intimate knowledge of the firm.

DIRECTORS AS A RESOURCE

In addition their fiduciary responsibilities and their role in reducing agency costs, directors also contribute knowledge and skills; information, counsel and advice; and links to the broader community. Such individuals bring diverse attributes, individual expertise and organizational experiences to the boardroom (Baysinger & Butler, 1985). In keeping with these other contributions, Pfeffer (1973) and Pfeffer and Salancik (1978) proffer a resource dependence perspective on board composition, in which individuals are nominated for their human capital (e.g., experience, expertise and reputation) and relational capital, linkages to other individuals and organizations (Hillman & Dalziel, 2003). As a provider of resources, the board helps reduce the organization's reliance upon external factors and better the firm's response to contingencies arising within its environment and among its stakeholders.

The provision of resources lessens organization uncertainty, which should translate into improvements in firm performance (Hillman & Dalziel, 2003). Pfeffer (1972; 1973) argues that

companies confronting increased environmental uncertainty have greater need for effective external linkages, thus should have larger boards and higher ratios of outside directors. Using a meta-analysis approach of 27 prior studies with a total of 131 samples, Dalton, Daily, Johnson and Ellstrand (1999) show a positive relationship between board size and financial performance after controlling for firm size, board independence, and financial and market performance. Dalton et al. (1999) do not suggest big is better, but rather larger boards allow for multiple members to satisfy duties and responsibilities related to control, advice and counsel, and providing resources. The question arises as to what size is sufficient to lever these multiple roles. Yet, the trend is towards smaller rather than larger boards (Korn Ferry, 2008) even as environmental uncertainty increases with increases in the pace of technological change, globalization, and regulation. Hence, board size seems too simplistic a metric for judging resource dependence theory (Boyd, 1990; Pearce & Zahra, 1992).

Analyses of the correlation between board composition and financial performance are also consistent with resource dependence theory. The question arises whether there is some mixture of insiders, affiliate directors and independent outsiders that leads to superior firm performance as a consequence of the board's independence from management. Dalton, Daily, Ellstrand and Johnson (1998), again using a meta-analysis approach of 54 studies of board composition, find little systematic evidence of board structure and performance. Although their arguments arise from agency theory, Bhagat and Black (1999; 2002) similarly report that there is no convincing evidence to suggest that board independence is consistently correlated with firm profitability or growth. However, Zahra and Pearce's (1989) literature survey suggests some evidence showing a relationship between board composition and financial performance, but note that composition seems complicated by other board attributes and roles.

Boyd (1990) argues that it is the number of interlocks (other directorships) held that should be the focus in studies of board composition. In other words, it is the type of directors sitting on the board. But that would suggest more focus on the director's business and social network (Koenig & Gogel, 1981) than human capital contribution. Pfeffer and Salancik (1978) suggest that directors, having demonstrated the competence necessary to supply or to access critical resources vital to the firm's success, bring four benefits to the organization. Outside directors act as boundary spanners – providing expertise and resources for managing external environmental factors, including 1) strategic advice and expertise; 2) communication channels to external organizations; 3) support from important elements outside the firm; and 4) legitimacy (Pfeffer, 1973; Pfeffer & Salancik, 1978). Insiders possess firm-specific information focused on internal problems and constraints (Fama & Jensen, 1983).

Based on these benefits, Hillman, et al., (2002) categorize directors as insiders, business experts, support specialists, and community influentials to show that U.S. airlines, following deregulation and facing added uncertainty related to increased competition and customer demand, altered the composition of their boards. As directors needed replacement, airlines shifted away from insiders, who were deemed necessary to satisfy the boards and the regulatory agency's demand for information, and towards support specialists and those individuals with community influence and prestige. Adapting Hillman's, et al. (2002) taxonomy to a sample of IPOs, Kroll, Walters and Le (2007) show young firms benefit when directors consist of original top management team members (insiders) and business experts selected to provide advice and counsel. Jones, Makri and Gomez-Mejia (2008) show that business expert and support specialist board members encourage family-owned companies to pursue growth via diversification. Mizruchi and Stearns show that the presence of directors associated with financial institutions increases borrowing (1994) and the types (1993) of financial institutions represented on boards are associated with the amounts and types of financing firms obtain. To summarize, the resource dependence empirical research has evolved to identifying particular types of directors, who match specific environmental needs, then examining their impact on the organization.

Resource dependence theory suggests outside directors are valued not only for their role as monitors but also for the experience, expertise, and guidance they provide. This viewpoint is consistent with movement towards more independent (of the CEO) boards as required by Sarbanes-Oxley, stock exchange requirements, and the desires of institutional investors. Whether directors strive to satisfy the needs of other constituencies in addition to maximizing shareholder wealth has not been extensively

studied (Hillman & Dalziel, 2003). We first examine whether a relationship exists between financial performance and the composition of the board as a whole, measured in terms of the director's specific linkage to other businesses, suppliers or the community. We hypothesize:

H3: The composition of the board of directors, based on the members' resource dependence role, has a positive impact on the company's financial performance.

Dalton, et al. (1999, p. 682) states, "Another potentially interesting extension (*of resource dependence theory*) may include board committees." Others have noted that much of the work is done in committee and not the board-at-large (Bilimoria & Piderit, 1994; Harrison, 1987; Kesner, 1988; Lorsch & MacIver, 1989; Peterson & Philpot, 2007; Peterson, Philpot & O'Shaughnessy, 2007). Bearden (1986) documents Singer Sewing Company's ties to financial institutions with directors specifically chosen by the CEO for their close personal relationships with the banking community when staffing the newly created finance committee. This action by Singer's CEO is consistent with Klein's (1998) assertion that it is not board composition per se that affects financial performance but rather how the board uses committee membership that determine its effectiveness. Accordingly,

H4: The composition of the finance committee, based on the members' resource dependence role, has a positive impact on metrics of the company's financial performance.

METHOD

Data and Sample

We sample the 2002 Fortune 500 list of United States largest companies, based on prior year gross revenues. Most companies in the sample are publicly held including 421 that list on the New York Stock Exchange, 53 on the NASDAQ, 3 that trade on the American Stock Exchange, and 23 that were either privately or mutually-owned, merged or acquired during the time period between inclusion in the Fortune 500 and release of proxy materials, or fell into bankruptcy and liquidation. In addition to these 23, missing data omits another 116 companies including the 23 banks for which Compustat does not provide cash flow information. The final sample consists of 361 companies.

To assess the degree to which financial performance depends upon the resource dependence role directors fulfill, we construct a classification/taxonomy matrix suggested by Pfeffer and Salancik (1978) and Hillman, et al., (2002). We randomly selected 1,667 directors (30% of 5,500). Biographical information of individuals preceding their election to the board as reported in proxy statements was read and categorized by each author. Differences in opinion were reconciled with help from faculty not associated with the project. The data in Table 1 show that our sample includes 251 (15.1%) insiders, 700 (42.0%) business experts, 417 (25.0%) support specialists, and 299 (17.9%) community influential board members.

Further delineation shows the sample includes 45 founders or family members and 206 management directors. Nominating committees apparently value business expertise as the plurality (700; 42.0%) of directors comes from within the corporate ranks, especially CEOs from publicly (228) and privately (169) traded companies. Twenty-five percent of directors are support specialists with almost half of those (45.5%) possessing expertise in investment (139) or commercial banking (51). Another 40.7% have backgrounds in government (104) or the legal community (66). University faculty and administrators and research institute employees (177) dominate directors selected for their community ties.

TABLE 1
THE RESOURCE DEPENDENCE ROLE OF U.S. FORTUNE 500 DIRECTORS, 2002 (N = 1667)

Taxonomy	Classification	N	Classification	Taxonomy
Insiders	Founder or family	45	17.9%	
	Management	<u>206</u>	82.1%	
	Subtotal	251		15.1%
Business	CEO public company	228	32.6%	
Experts	Management publicly traded company	237	33.9%	
	CEO privately held company	169	24.1%	
	Management privately held company	33	4.7%	
	Management foreign company	<u>33</u>	4.7%	
	Subtotal	700		42.0%
Support Specialists	Investment banking / money management	139	33.3%	
	Commercial banking	51	12.2%	
	Legal	66	15.8%	
	Government	104	24.9%	
	Public relations, affairs or advertising	14	3.4%	
	Non-university industry specialists	<u>43</u>	10.3%	
	Subtotal	417		25.0%
Community Influential	University or research institute	177	59.2%	
	Management non-profit organization	26	8.7%	
	Medical services or foundation	24	8.0%	
	Philanthropy or community foundation	26	8.7%	
	Historical or cultural organization	11	3.7%	
	Community leader	<u>35</u>	11.7%	
	Subtotal	299		17.9%
Total		1667		

We examine finance committees in the year Sarbanes-Oxley was enacted and report committee membership on executive, nominating, compensation, auditing, and public affairs for comparison purposes in Table 2. We find 174 of the sampled 361 (48.2%) Fortune 500 boards included a finance committee in 2002 with an average membership of 5.2. In comparison, Heidrick (1985) reported that 53.7 percent of 520 companies had finance committees in 1981. Klein (1998) shows 201 (202) finance committees for firms listed on the S&P 500 in 1992 (1993) with an average number of 5.5 committee members. Klein's classification system shows 21.8 (18.8) percent insiders, 59.2 (61.7) percent outsiders, and 19.0 (19.5) percent affiliates held finance committee seats in 1992 (1993). The sampling distribution amongst finance committee members using the Pfeffer Salancik (1978) taxonomy is 37 (11.2%) insiders, 135 (40.9%) business experts, 106 (32.1%) support specialists, and 52 (15.8%) community influential. The proportions – 14.2% insiders, 45.5% business experts, 30.5% support specialists, and 9.8% community influential – are similar for the population of companies whose boards of directors include a finance committee. Over the 10 year period from Klein's to ours, finance committee membership shifted

towards fewer insiders and more affiliates/support specialists with outsiders/business experts plus community influential proportions remaining about equal.

The number of directors on the board as a whole also shrank from 12.3 to 11 (Klein (1998) vis-à-vis our sample) and the number of insiders (management-employees along with founders and family members) sitting on nominating (11.5% to 4.8%), compensation (4.0% to 3.1%) and audit (1.4% to 1.6%) committees decreased from 1992 to 2002.¹ In addition to the finance committee, membership is not regulated for the executive and public affairs committees. Kenny (2004) notes both a diminished role and decline of executive committees among Fortune 500 companies. The public affairs group represents a collection of committees charged with a variety of charitable, social, philanthropic and/or environmental issues.

TABLE 2
BOARD AND COMMITTEE COMPOSITION FOR 2002 FORTUNE 500 FIRMS

	Board	Executive	Nominating	Compensation	Audit	Finance	Finance (Pop.) ³	Public Affairs
Insiders ²	251 15.1%	97 29.6%	29 4.8%	18 3.1%	11 1.6%	37 11.2%	127 14.2%	17 6.7%
Business Experts	700 42.0%	116 35.4%	281 46.6%	313 54.7%	350 50.1%	135 40.9%	408 45.5%	91 36.1%
Support Specialists	417 25.0%	80 24.4%	156 25.9%	133 23.3%	198 28.4%	106 32.1%	274 30.5%	79 31.3%
Community Influential	299 17.9%	35 10.7%	137 22.7%	108 18.9%	139 19.9%	52 15.8%	88 9.8%	65 25.8%
Total	1667	328	603	572	698	330	897	252

Note: Committee membership not mutually exclusive.

Model

Standing committees play an important role in corporate governance, as most work is done at this level and then forwarded to the board for additional consideration (Anderson & Anthony, 1986). Finance committees review and recommend financing, dividend, investment, and risk management plans and policies of the company and its relationship to the financial community (Braiotta & Sommer, 1987). For example, Altria's finance committee is charged with monitoring:

“the Company’s financial condition, oversees the sources and uses of cash flow and the investment of certain employee benefit plan assets and advises the Board with respect to financing needs, dividend policy, share repurchase programs and other financial matters”
(Source: Altria Group, Inc., DEF 14A, April 24, 2008).

The model and variables are estimated with an OLS regression used to examine the cross-sectional relation between board composition and various metrics of firm performance. Following Klein (1998), three separate measures of performance are analyzed. The Jensen Productivity [JPROD] metric measures the corporation's investment strategies and the productivity of its long-term assets (Jensen, 1994). It equals the change in the market value of the firm's equity less a benchmark return on investment; the latter defined as the change in net property, plant and equipment times an estimated eight percent cost of capital (Jensen, 1994). The JPROD metric is deflated by sales. Market profitability is measured as annual

total return [MKRTX] including the effects of cash equivalent distributions. Our accounting measure of profitability is the ratio of operating margin before depreciation [OMBD] as a percentage of net sales.

Proxy statements delivered in 2002 report committee membership in 2001. To the extent that committee members recommend changes in financial policy, it is unlikely that the effect will be immediately reflected in the performance metrics. Thus, the relation between the dependent variables and these metrics are computed for 2002.

The OLS model is defined as:

$$\text{Performance Metric} = \beta_0 + \beta_1\text{FCOM} + \beta_2\text{INVCF} + \beta_3\text{FINCF} + \beta_4\text{DVPOL} + \beta_5\text{DSE} + \beta_6\text{INSDR} + \beta_7\text{BSXPRT} + \beta_8\text{SUPSPC} + \beta_9\text{BETA} + \beta_{10}\text{INST\%} + \beta_{11}\text{LMCAP}.$$

FCOM is a dummy variable that equals 1 if a finance committee exists and 0 otherwise. If finance committees provide value above and beyond the guidance the board provides management towards maximizing stockholder wealth, realizing a significant and positive coefficient would be consistent with the first hypothesis.

Finance committee members are responsible for providing financial guidance, monitoring cash flows, dividend policy, and financing (Braiotta & Sommer, 1987). INVCF and FINCF are the net cash flows from investing and financing, respectively, deflated by sales (Klein, 1998). Cash dividends are omitted from financing cash flows given the usual historical stability of the payment. However, changes in dividend policy are the committee's responsibility. DVPOL is a categorical variable equaling 1 when dividend policy changes due to the origination and -1 when dividend policy results in the cessation of cash dividends; 0 otherwise. Financial leverage, DSE, is measured as the ratio of long term debt to equity. Financial variables were obtained from S&P's Compustat data base.

Explanatory variables include a categorization of directors based on their perceived resource dependence role (Hillman, et al., 2002; Hillman, Keim & Luce, 2001). Peterson and Philpot (2007) and Peterson, et al., (2007) report that committee composition varies based upon the role directors play as stakeholders. We compute the proportion of resource dependent classifications by firm and differentiate insiders (INSDR), business experts (BSXPRT), and support specialists (SUPSPC). In the results shown below, community influential directors are included in the estimate for the intercept because of the unit sum constraint in regression procedures. To the extent that board and committee composition matters, we would expect to find significant and positive parameter estimates for these variables.

Financial institutions have been shown to play an important role in corporate governance (Useem, Bowman, Myatt & Irvine, 1993). Unlike individual investors, who may show disapproval of firm policies or performance by selling their holdings, institutional investors can actively force change in the boardroom rather than incur large costs when management pursues its own interests (Davis & Thompson, 1994; Useem, et al., 1993). Carleton, Nelson and Weisbach (2002) found that TIAA-CREF's concerns about governance led to private correspondence between itself and 45 companies that subsequently resulted in positive changes in 87% of the targets. Smith (1996) analyzing CalPERS' effectiveness at shareholder activism, reports stock prices improved but there were no significant improvements in operating performance and alternative accounting measures for companies targeted. Thus, institutional ownership INST%, measured as the proportion of institutional investors to shares outstanding as reported in Standard & Poor's *Security Owner's Stock Guide*, June 2002, is included.

The model includes two variables to control for variability in company characteristics. BETA is obtained from a market model regression using company and S&P500 monthly returns including dividends for the preceding five year time period. The natural log of market capitalization LMCAP is used to measure corporate size.

Variable means and standard deviations are reported in Table 3. Sample companies average \$10.8 billion in 2001 revenues. Sixty-four (64) percent of shares outstanding are held by financial institutions. Mean beta measured 0.8. Both the Jensen Productivity and the market return metrics were negative, most likely due to the poor performance of the market in 2002 when the S&P500 declined 22.5%. However,

operating margin before depreciation is almost 19%. Investment and financial (excluding cash dividends) cash flows as a percentage of sales are 12% and 3%, respectively. Financial leverage, measured as long term debt to book equity, is almost 2.5. Six percent of the companies initiated or omitted cash dividends. Composition of the boards is 15% insiders, 42% business experts, 25% support specialists and 18% community influential. Forty-eight (48) percent of sample companies have a board finance committee.

TABLE 3
SUMMARY STATISTICS

	Variable	Description	Mean	Stdev
1	JPROD	Market value less 8% ROI (Change in PPE) deflated by sales	-0.28	0.67
2	MKRTX	Market return including cash distributions	-6.37	31.50
3	OMBD	Operating margin before depreciation	18.82	15.43
4	FCOM	Finance committee membership	0.48	0.50
5	INVCF	Investment cash flows deflated by sales	-0.12	0.30
6	FINCF	Financial cash flows deflated by sales	0.03	0.31
8	DVPOL	Dividend policy change: 1 origination, -1 cessation, 0 otherwise	0.06	0.23
9	DSE	financial leverage LTD/E	2.46	17.20
10	INSDR	Corporate insider	0.15	0.36
11	BSXPRT	Business expert	0.42	0.49
12	SUPSPC	Support specialist	0.25	0.44
13	COMINF	Community influential	0.18	0.38
14	BETA	Beta	0.80	0.66
15	INST%	Institutional ownership	0.64	0.17
16	LMCAP	Market capitalization	16.20	1.40

RESULTS

Findings and Discussion

The research question centers on whether the presence of a board-level finance committee adds value. T-tests for differences in mean values indicate that firms with finance committees realized a greater, albeit negative, Jensen productivity measure than firms without finance committees (JPROD -0.24 v -0.32; $t = 2.15$, $pr 0.03$). Market returns for 2002 were negative for both groups but the difference is not significant (MKRTX -4.82 v -8.85; $t = 1.30$, $pr 0.20$). Finally, 2002 operating margins were significantly better for those corporations whose boards includes a finance committee (OMBD 18.59 v 15.96; $t = 1.78$, $pr 0.08$). These results are consistent with hypothesis one that the existence of a finance committee affects financial performance.

A major goal for boards of directors is to maximize shareholder value through the efficient allocation and management of scarce resources. OLS model and parameter estimates are shown in Table 4. The Jensen Productivity metric measures the market's perception of stockholder wealth creation. It measures management's performance at realizing long-term asset productivity and the success of its investment strategies from one year to the next (Jensen, 1994). When JPROD is regressed on the explanatory variables, the coefficient on FCOM is not significant ($t = 0.74$). Thus, we do not find support for the first hypothesis that finance committees add value after controlling for other variables. There exists a positive relationship between the variability in JPROD and investment ($t = 1.96$) and financial ($t = 2.27$) cash flows and changes in dividend policy ($t = 2.47$). None of the board composition metrics are significant which suggests little support for hypothesis three.

Separate regressions are shown for companies whose boards of directors include (row 2) and do not include (row 3) a finance committee. The cash flow measures along with the proportion of insiders are significant and positive in explaining the Jensen metric when the board includes a finance committee. These results are consistent with a committee charged with overseeing the sources and uses of cash flows and that insiders on the committee play a prominent role in making investment and financing decisions. When the board does not include a finance committee, changes in dividend policy – i.e., dividend initiation or omission – are significant and the explanatory power of cash flows becomes insignificant. Even though the committee may be charged with advising the board with respect to dividends, the board as a whole makes the decision to change policy.

TABLE 4
OLS REGRESSION: COMMITTEE MEMBERSHIP AND RESOURCE DEPENDENCE

DEPENDENT VARIABLE	JPROD			MKRTX			OMBD		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
	Full	w/ FC	w/o FC	Full	w/ FC	w/o FC	Full	w/ FC	w/o FC
INT	2.25 6.17***	2.13 3.70***	2.22 4.63***	17.73 0.93	17.35 0.59	12.93 0.50	-22.68 3.06**	-17.27 1.60	-22.51 2.23*
FCOM	0.04 0.74	—	—	0.90 0.30	—	—	0.30 0.25	—	—
INVCF	0.55 1.96*	1.60 3.16**	0.06 0.18	20.11 1.64#	30.83 1.19	23.18 1.57	-24.23 4.83***	-58.36 6.14***	-14.94 2.44*
FINCF	0.61 2.27*	0.95 1.89#	0.23 0.68	26.48 2.14*	29.54 1.13	30.78 2.05*	-1.96 0.40	-25.62 2.68**	5.13 0.85
DVPOL	0.11 2.47*	0.04 0.60	0.15 2.54*	3.49 1.55	1.48 0.44	4.76 1.51	1.37 1.54	2.56 2.05*	0.16 0.13
DSE	0.00 1.31	0.04 1.13	0.00 1.16	-1.80 2.54*	-2.93 1.81#	-1.18 1.40	-0.03 0.87	0.99 1.67#	-0.04 1.04
INSDR	0.23 1.20	0.66 1.87#	0.20 0.87	18.90 1.97*	28.95 1.59	16.70 1.40	-8.87 2.32*	-9.51 1.46	-9.70 2.01*
BSXPRT	0.05 0.36	-0.33 1.36	0.18 1.00	8.73 1.17	10.00 0.80	9.12 0.94	-4.74 1.59	-0.15 0.03	-6.55 1.68#
SUPSPC	0.11 0.70	-0.11 0.38	0.20 0.99	6.86 0.83	-0.70 0.05	11.54 1.07	1.24 0.38	-1.01 0.20	1.20 0.30
BETA	-0.31 7.39***	-0.41 5.26***	-0.27 5.24***	-18.37 8.64***	-15.34 3.84***	-20.40 7.69***	-2.41 2.91**	-2.70 1.98#	-2.68 2.54*
INST%	0.25 1.53	0.44 1.61	0.21 1.02	11.45 1.38	15.19 1.07	9.81 0.92	6.94 2.12*	-8.24 1.62	-4.93 1.15
LMCAP	-0.16 7.76***	-0.14 4.09***	-0.17 6.19***	-1.52 1.46	-1.47 0.86	-1.17 0.84	2.83 6.87***	2.16 3.41***	2.90 5.26***
F	12.92	8.16	8.07	9.62	2.71	8.17	20.91	13.54	13.10
R ²	0.29	0.37	0.27	0.22	0.12	0.26	0.40	0.49	0.38
N	320	125	195	332	130	202	333	132	201
Student t-statistics shown below parameter estimate. # p < 0.10 * p < 0.05 ** p < 0.01 *** p < 0.001									

The FCOM parameter estimate is not significant when either MKRTX or OMBD are the performance metric. Total market return may be a noisy measure because it is more sensitive than the Jensen metric to investor enthusiasm. As recent events such as the technology and housing bubbles have shown,

speculators can push stock and asset prices to unsustainable levels followed by a rather abrupt fall that takes down entire market sectors without regard to underlying values. Board and committee performance should be evaluated based upon long-term strategies and performance and not necessarily the vagaries of the market (Hillman & Keim, 2001). The inherent problem in any accounting metric like operating performance is that as a measure it is short-term in nature (Briloff, 1981; Fisher & McGowan, 1983; Hayes & Abernathy, 1980), focused upon historical performance (McGuire, Sundgren & Schneeweis, 1988), and can be manipulated by management (Bentson, 1982; Briloff, 1972; Watts & Zimmerman, 1978).

Hypothesis 3 focuses on the composition of the board with implications for company financial performance. Prior work has generally been unable to find a positive relation between board composition and firm performance using a variety of board classification schemes and data sets. Our intent in testing firm performance vis-à-vis whole board composition is to validate similarities between our findings and others and to provide a baseline upon which to compare tests of finance committee composition and performance.

There is evidence that management (INSDR) has a significant and positive effect on JPROD (finance committee) and MKRTX (full sample). Insiders may provide strategic guidance through their service on the finance committee, a finding consistent with Klein (1998) and Baysinger and Hoskisson's (1990) argument that insiders may be better at strategic decisions than outsiders. However, the coefficients on INSDR (full sample and no finance committee) and BSXPRT (no finance committee) are significant and negative for OMBD. Most of the resource dependence variables are not significant which suggests that board composition has little direct effect on firm performance, a finding consistent with prior empirical studies (Bhagat & Black, 1999; 2002; Dalton, et. al., 1998).

Several other observations can be made. Both BETA and company size (LMCAP) are statistically significant in explaining the variability in the productivity and accounting performance measurements. Only beta contributes towards explaining market performance. Extant research in investments shows that, on average, returns volatility and beta are inversely related to company size. Thus, the negative coefficients suggest a stronger explanatory relationship between the three dependent variables and large market cap, small systematic risk companies.

Our second hypothesis asks which group of board members helps set corporate financial strategy as measured by the odds of finance committee membership. We used the resource dependence taxonomy shown in Table 1 to classify all 2,112 directors from those 174 U.S. Fortune 500 boards including a finance committee in 2002. The population consists of 399 (18.9%) insiders, 957 (45.3%) business experts, 503 (23.8%) support specialists, and 253 (12.0%) influential community members. Logistic regression is then used to predict the odds that finance committees will be staffed with business experts, specialists, or community influential members (Hillman, et.al., 2002) after controlling for investment, financing, and dividend policies (Braiotta & Sommer, 1987) and other firm characteristics. The model is:

$$FCOM = f (INVCF, FINCF, DVPOL, DSE, BSXPRT, SUPSPC, COMINFL, BETA, INST\%, LMCAP)$$

with participation on the finance committee measured dichotomously – 0 representing membership and 1 non-membership.

The statistical procedure estimates the odds of a director being included on the finance committee with odds defined as the ratio of the predicted probability of service to the predicted probability of not serving. Parameter estimates for BSXPRT, SUPSPC and COMINFL measure the likelihood that an outside board member from a particular group will sit on the committee. Odds increase with the magnitude of the coefficient, *ceteris paribus*. The sign and significance of the intercept show the status of insiders on committee membership.⁴ Partial regression coefficients indicate the direction and magnitude of each variables influence, holding the others constant, on odds (Cohen, Cohen, West & Aiken, 2002). Companies without a finance committee are excluded.

Parameter coefficients are reported in Table 5. The chi-square statistic showing model fit is significant indicating that parameter coefficients can be meaningfully interpreted. In the first model, significant and positive coefficients for BSXPRT and SUPSPC predict finance committees composed of business experts and support specialists. In the second model, insiders are substituted for community influential board members. The coefficient on INSDR is not significant suggesting that owners, family members, and management are not likely to find themselves seated on the committee.

TABLE 5
LOGISTIC REGRESSION: COMMITTEE MEMBERSHIP AND RESOURCE DEPENDENCE

DEPENDENT VARIABLE	FCOM MEMBER					
	(1)	(2)	(3)	(4)		
INT	-0.76 50.21***	-0.63 22.67***	-0.78 1.19	-0.72 0.99		
INVCF			1.88 11.53***	1.33 4.96*	B1 PUBCEO	0.32 4.24*
FINCF			1.79 10.65***	1.26 4.37*		B2 PUBMGT
DVPOL			0.14 3.05	0.11 1.81	B3 PRVCEO	0.33 2.61
DSE			0.01 0.05	0.01 0.14		B4 PRVMGT
INSDR	—	-0.13 0.61	—	—	S1 IB	1.52 43.92***
BSXPRT	0.46 13.65***	0.33 5.07**	0.48 10.88***	—		S2 CB
SUPSPC	0.94 45.25***	0.81 25.66***	1.11 45.93***	—	S3 LEGAL	0.62 2.99
COMINFL	0.13 0.61	—	0.24 1.41	0.11 0.36		S4 GOV'T
BETA			0.09 1.25	0.06 0.44	S5 PR	1.47 5.77*
INST%			-0.48 1.58	-0.35 1.17		
LMCAP			0.02 0.18	0.02 0.18		
CHI-SQ	54.50***	54.50***	73.40***			88.6***
NOBS	211	211	157			1573
RESPONSE	897	897	688			688

B1 and B2 are the proportions of public company CEOs and management; B3 and B4 are private company CEOs and management. S1 and S2 are investment and commercial bankers; S3 is legal (judges and lawyers); S4 is government (ex-politicians and regulators); and S5 is public relations specialists.

Wald χ^2 statistic reported below parameter estimate.
 * p < 0.05 ** p < 0.01 *** p < 0.001

Results for the third model, consistent with models one and two, also suggest finance committees staffed with business experts and specialists after controlling for investment (INVCF) and financing (FINCF). These two variables are consistent with the duties and responsibilities for which the finance committee has been charged. Company factors BETA, INST% and LMCAP are not significant in

affecting the likelihood of committee membership. The fourth model further differentiates directors into business experts or support specialists using the taxonomy shown in Table 1. It shows that committee members are more likely to be CEOs and senior management of publicly traded companies or bankers. Surprisingly, public relations experts also sit on this committee.

Overall, the findings support hypothesis two that finance committee assignments fall to members possessing expertise in finance and lend additional support to Mizuchi and Stearns (1993; 1994) arguments and findings that particular types of directors (those associated with financial institutions) are identified to match specific organizational needs (amounts and types of borrowing). This finding is not consistent with Klein (1998), who argues that employee-directors should hold a seat on the finance and investment committee maximizes shareholder wealth as it proxies for their role within the organization. It should be noted that Klein (1998) classifies directors as insiders, outside board members and affiliates.

Hypothesis four questions whether the composition of the finance committee itself adds value. Table 6, model 1, shows a significant and positive relationship between the corporate investment strategy and the productivity of long-term investments (JPROD) and committees composed of business experts (BSXPRT $t = 2.43$), support specialists (SUPSPC $t = 1.93$), and insiders (INSDR $t = 1.64$). This finding complements results shown in Table 5 pertaining to staffing finance committees with members possessing a financial background. It also supports Klein's (1998) assertion that insiders provide value by way of a

TABLE 6
OLS: RESOURCE DEPENDENCE OF THE FINANCE COMMITTEE

DEPENDENT VARIABLE	JPROD	MKRTX	OMBD
	(1)	(2)	(3)
INT	1.46 2.43*	9.75 0.30	-24.20 1.95 [#]
INVCF	1.40 3.10**	46.13 1.92 [#]	-35.96 3.92***
FOMCF	0.92 2.13*	45.98 1.96 [#]	-5.02 0.56
DVPOL	0.04 0.64	4.14 1.21	2.75 2.11*
DSE	0.03 1.02	-3.40 2.06*	0.79 1.26
INSDR	0.58 1.64 [#]	9.53 0.50	-12.21 1.68 [#]
BSXPRT	0.72 2.43*	-2.83 0.18	0.90 0.15
SUPSPC	0.67 1.93 [#]	-2.88 0.15	3.99 0.58
BETA	-0.35 4.97***	-10.32 2.74**	-2.08 1.51
INST%	0.20 0.77	13.08 0.91	-11.01 2.08*
LMCAP	-0.13 4.03***	-0.53 0.30	2.72 4.04***
F	7.98***	2.04	11.38***
R ²	0.36	0.07	0.44
N	124	130	131
Student t-statistics shown below parameter estimate.			
# p < 0.10			
* p < 0.05			
** p < 0.01			
*** p < 0.001			

seat on this committee. Helping explain variation in JPROD are net cash flows from investment (INVCF $t = 3.10$) and financing (FINCF $t = 2.13$) along with beta (BETA $t = 4.97$) and market capitalization (LMCAP $t = 4.03$). Models 2 and 3 show committee composition does not explain market returns (MKRTX) or operating margin before depreciation (OMBD).

Limitations

There are several problems inherent in this type of analysis. First, the U.S. Fortune 500 changes annually with 20 to 30 companies entering the list as others depart due to takeovers, mergers and acquisitions, bankruptcy and liquidation, or some other reason. Moreover, the mix of public corporations and private firms is not static. That makes comparisons across different studies, as well as a single longitudinal study, difficult. There is also evidence of size bias with large firms having not only more directors but also more committees (Peterson, et al., 2007). It may well be that as firms increase the number of board level committees, the traditional functions of a finance committee may be in part spread among other committees, weakening inference about the efficacy of a finance committee.

Does committee membership adequately represent an individual's current contribution to performance or does board and committee composition reflect past performance? Hermalin and Weisbach (1988) and Pearce and Zahra (1992) report correlations between poor past performance and subsequent changes in boards towards more independent directors. Thus, finding a significant relationship between committee composition and performance may be evidence of a persistence factor and not do to how a member's unique knowledge, skills and experiences are used. On the other hand, Bhagat and Black (1999) find no evidence that board composition is correlated with either lagged or contemporaneous measures of company profitability or growth. These directors may have been sitting on the finance committee for several years preceding measurement and recommendations may have already been realized by improvements in performance. Committee structure may matter, but any material benefit from selecting one director rather than another may not be realized until years later. That type of assessment would require committee notes and minutes of board meetings. Further, some directors may serve as figureheads with little real input (Burgess & Tharenou, 2002).

Several limits on the statistical analysis also bear mention. An endogenous relationship may exist between board composition and company performance. If so, ordinary least squares will produce biased estimates (Pindyck & Rubinfeld, 1991), but any simultaneous equation techniques that attempt to correct the problem may produce results that are no more and perhaps less reliable because they are highly sensitive to the specific model being tested (Barnhart & Rosenstein, 1998; Bhagat & Black, 1999). And in studies of board composition, OLS estimates should not be casually dismissed (Barnhart & Rosenstein, 1998). In addition, using categorical variables to classify directors according to some taxonomy limits our understanding of the broad range of experience and expertise these individuals bring to the boardroom. However, for purposes of analysis discrete categorization of director background is necessary.

Finally, in any study of director resource dependence, it is necessary to assume that firms use directors with the goal of maximizing the benefits of the directors' primary area of expertise. If a non-management director has a background in finance, it is also assumed that the value-maximizing firm will use him or her as a resource consistent with their expertise. It is possible that this is not always the case, and when it is not inferences about the efficacy of directors based on resource dependence are hard to make.

CONCLUSION

We examine the use and staffing of board-level finance committees by very large United States firms in 2002. Prior work by Klein (1998) finds that the mere existence of a finance committee has no effect on firm performance. Since that time (1992-3), changes in corporate governance practice in response to government and exchange regulations have left the finance committee as one of few flexible board committees, both in its existence and staffing. We find some evidence that companies with board-level

finance committees outperform those without in comparisons of the mean values for the financial metrics. However, differences are small after controlling for other company characteristics.

We also examine whether boards maximize their members' contribution through their placement on the finance committee. Contribution is measured based upon a resource dependence taxonomy in which directors are categorized according to their role as insider/management, business experts, support staff professionals or influential within the community. The flexibility of the finance committee allows it to be staffed with management/insiders as well as outsiders with particular financial expertise. We find evidence that the committee will be staffed with top management of publicly traded companies and investment and commercial bankers. Moreover, finance committees have a positive effect on corporate investment strategy and the productivity of long-term investments as measured by the Jensen (1994) productivity metric. These findings supplement Klein (1998), but extend the result to include the potential efficacy of other experts on the committee.

A major premise underlying agency theory is the director's fiduciary obligation to monitor management behavior and maximize stockholder wealth. Resource dependence theory posits complimentary roles for board members, who may be valued for their network to other organizations and constituencies or selected to provide strategic guidance to management. Ideally, nominating committees will recommend the best individual available recognizing that the candidate, if elected, will have other responsibilities. Committee work is an important part of a board member's duties. Firms may do well to make use of finance committees led by members of management and outside directors who are themselves business managers or financial experts.

ENDNOTES

1. Reasons vary for declining insider representation on these three committees. In 1980, the American Bar Association Committee on Corporate Laws recommended nominating committees should consist entirely of independent directors, although some committee members believed that CEOs should at least participate in approving who its members put forth as candidates (Business Lawyer, 1980). Management presence on compensation committees declined following 1993 changes to IRS regulations [§162(m)] that disallowed tax deductibility of excessive (over \$1 million) executive compensation in cases where insiders participated on the compensation committee. In 1977, the SEC approved an NYSE rule requiring all listed domestic companies to establish an audit committee comprised solely of independent directors free from any relationship that would interfere with the exercise of independent judgment as a committee member.
2. Section 303A Corporate Governance Rules of the New York Stock Exchange were approved by the SEC on November 4, 2003, and amended on November 3, 2004. Section 303A defines director independence including the requirement that nominating/corporate governance, compensation, and audit committees be composed entirely of independent directors. On November 2, 2004, the NYSE filed amendments giving listed companies until their first annual meeting after June 30, 2005, to replace a director who was independent under the prior test but who would not be independent under the proposed revised Section 303A.02(b)(iii) [immediate family member relationship to the firm].
3. Shown is the resource dependence classification of the finance committee for the population of 174 companies whose boards have a finance committee. The population (2,112) consists of 399 (18.9%) insiders, 957 (45.3%) business experts, 503 (23.8%) support specialists, and 253 (12.0%) community influential members.
4. Note that the four alternative resource dependence classifications are fully specified by three dummy variables with the fourth implicit. The introduction of a separate insider classification would add a non-independent equation in the derivation of the least squares estimators (Pindyck & Rubinfeld, 1991, p. 106-108).

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