Rough Year For The Firm: Should Quick Governance Changes Be The Response?

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Rough Year For The Firm: Should Quick Governance Changes Be the Response?

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Note: The views expressed in this paper are those of the authors and do not necessarily represent those of the U.S. Air Force Academy, the U.S. Air Force, the Department of Defense, or the U.S. government.

Research Questions
Organizations face significant pressure to act following big dips in firm performance. But what should they do? Faced with intense shareholder calls to take swift action, firms need to make the right decisions—and quickly—to right the ship and raise performance to shareholder expectations.

One response is to fire the CEO. Another is to shake up the board, which could involve dismissing board members or changing the size or mix of the board. While these kinds of responses are common, it’s unclear whether firm performance improves after making such changes.

This issue intrigued John Easterwood, Ozgur Ince (both from Virginia Tech), and Charu Raheja (Wake Forest University). In their recent article in the *Journal of Corporate Finance*, Easterwood and his colleagues studied firms that experienced “negative performance shocks”—sudden, versus sustained, drops in performance. Moreover, they investigated how firm performance responded among those firms that made changes to the board structure in response to such a shock.

Understanding the relationship between changes in board structure and firm performance is important because boards are like sheriffs hired to protect towns. Not only are boards responsible for hiring and firing CEOs and setting executive compensation, they also monitor and approve CEO initiatives. Consequently, making changes to the board can have long-range impacts on firm performance.

Study Design and Method
Easterwood and his colleagues studied domestic, nonfinancial firms with at least $75 million of total assets between 1993 and 2002. Firms were classified as sustaining a negative performance shock if their performance (i.e., industry-adjusted operating return on assets) was initially at or above the top 50% of firms but quickly shifted and dropped them into the bottom 25% the following year. Using these criteria, they found 278 firms in 75 industries that experienced a staggering median year-over-year performance decline of 21%. The average firm saw its stock decline by over 50%, which suggests investors thought the performance declines were significant and didn’t expect conditions to improve. These performance swings are not entirely surprising given that nearly 25% of the study’s sample consisted of high technology firms, specifically computer and data processing services. Furthermore, almost 25% of the sample experienced their “performance shock” in 2001, coinciding with the end of the dot-com bubble.

At the time of the performance shock, the average CEO had been at the helm for more than six years, and over 60% were board chairs. CEO tenure, ownership in the firm, status as a founder, and duality (serving as both CEO and board chair) are measures of CEO influence, or strength. This is important because powerful CEOs wield more influence over strategic decisions. Boards averaged seven directors, with about 40% serving as employees or close associates of the firm and about 60% independent. Board independence is an important measure because independent boards are more effective at monitoring CEOs. Easterwood and his colleagues studied relationships among CEOs’ tenure and duality, board composition, and firm performance to discover which arrangements worked best for firms during the aftermath of negative performance shocks.

**Key Findings**

Firms with sudden performance drops replaced weak CEOs (i.e., less powerful CEOs with low tenure and no duality) 62% more often than their strong counterparts. This figure jumped to 94% in the absence of strong external forces, such as independent directors and large shareholders.
Nevertheless, even 25% of the strong CEOs departed within a year following the performance shock, suggesting that strong leadership alone won’t save the CEO. Of particular interest was when the CEO is weak and outside influence is low (outside influence is measured using board independence, high outsider stock ownership, and high ownership of non-CEO managers and directors). CEO departures were highest in this situation, with over half of CEOs experiencing replacement. And regardless of CEO leadership strength, one-third of the sample’s CEOs departed within a year after the performance shock and over half left within three years—double the rate of comparable firms.

Boards fared no better following negative performance shocks, with the average underperforming firm having 40% board member turnover. Easterwood and his colleagues also found that average board size increased in the three years following the shock. This might be because boards bring in new members who can provide needed advice and who have ties to key external organizations (Hillman & Dalziel, 2003). Finally, Easterwood and his colleagues did not find any appreciable difference between the proportion of independent directors serving on the board in a control sample versus those that served on a board that experienced a performance shock. This non-result seems inconsistent with prior studies showing that insiders tend to leave while outsiders tend to join boards during tumultuous times. Nevertheless, the high level of CEO turnover and board turnover suggests that the standard reaction to poor performance is to replace experienced managers and board members as well as to add new board talent.

But does all of this activity improve a bad situation? Easterwood and his colleagues found that while most firms in the sample generally improved their own performance they still continued to underperform relative to their industry. And replacing the CEO who oversaw the performance shock did not affect the firm’s performance during the recovery. Only changes to the board affected recovery. Among strong CEOs, board turnover slowed recovery. One possibility is that the board’s effort to right itself through turnover further decreases stability, thereby holding back performance.
Another possibility is that strong CEOs might use the board as a scapegoat for the performance shock, replacing board members as a tactic to divert attention away from the CEO. Among firms with weak CEOs, Easterwood and his colleagues found faster recoveries if boards were large and independent. This is consistent with the notion that board independence helps CEOs focus on what matters most to shareholders.

Conclusions and Implications

The key conclusion in this study is that following periods of negative performance shocks, strongly led firms should not necessarily stir the pot and replace board members, nor should firm leadership actively seek to rebalance board composition. Although some directors may resign to maintain their own reputation, Easterwood and his colleagues suggest that board turnover should be discouraged, as should attempts to rebalance boards in the spirit of independence. When managers take quick action by mixing things up on the board, the evidence suggests that performance does not recover as quickly as in steady-state situations. Indeed, Easterwood and his colleagues found that firing board members and/or changing board composition under the nose of a strong CEO ends up doing more harm than good. Incidentally, changing CEOs does not affect the recovery in any appreciable manner. In short, sometimes the best course of action is to stick with the team already in place.

The study has other implications for management scholarship. Future studies looking at this concept could examine the resource provision aspect of boards. Given that Easterwood and his colleagues show that board changes could be unwarranted, researchers could examine how troubled firms reach out to external constituents. It is possible that the more successful firms better leverage existing board members’ social networks.

Management practice can also benefit from this study. When firms suffer negative performance shocks, the top management team is pressured to act quickly. Prior research suggests that when managers experience stressful situations, they often limit their range of possible alternatives (Staw, Sandelands, & Dutton, 1981). One common alternative is making changes to
boards, but Easterwood and his colleagues suggest that managers may want to move board restructuring further back in their playbooks. Instead, top management might work with its experienced board to leverage their intimate knowledge of the situation to revisit and correct it.

So what changes should firms make when they experience negative performance shocks? While cleaning house by replacing board members or increasing their independence from management may seem logical and even quite popular, Easterwood and his colleagues have shown that the ensuing performance results tend to disappoint. The evidence they present indicates that boards of directors represent valuable, intangible assets that top managers should turn to, rather than run away from, when their firms are confronted with sudden dips in performance. In fact, an important responsibility of boards is to provide advice and counsel. Board members may be able to provide sound and experienced reasoning when the ship hits an iceberg—exactly what top management teams need to maintain buoyancy.

References

