



Impact of Board Composition on Critical Board Decisions - Evidence from Nigeria

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ABSTRACT

The Securities and Exchange Commission in Nigeria (SEC), in keeping with her mandates of promoting good corporate governance in Nigeria and also complying with the global trend, recommended Code of Corporate Governance for quoted firms in Nigeria in 2003. The code made strong recommendations for the separation of the position of the CEO and the board chair, and the dominance of outside directors, among others for quoted firms in Nigeria. The recommendations are geared towards resolving the principal-agency problem which is grounded in the agency theory. Agency problem arises whenever managers have incentives to pursue self-interest (self-serving behaviour) at the expense of shareholders. Most studies on corporate governance focused on how to effectively monitor the agents (resolving the conflict) against self-serving behaviour in order to protect shareholders interest. Although it should be conceded that resolving the principal-agent problem is an important issue in the corporate governance of firms, the global financial and economic crisis of 2007/08 exposed other forms of weaknesses in firms' corporate governance systems, particularly their critical decisions. It has been argued that some corporate boards lacked independence; directors often failed to make meaningful contributions to safeguard the growth and development of the firms. This raises an important question of whether the insufficient representation of outside directors is the possible explanation of boards' failure to fulfill their monitoring roles. To test empirically whether board composition matters, it has been suggested that, rather than examining a board's monitoring effectiveness by using the firm financial performance as proxy, a more accurate evaluation can be gained by examining discrete decisions that involve a potential conflict of interest between management and shareholders. To add to the debate, this paper examined the impact of board composition on the critical decisions of Nigerian firms. The survey method was used in generating data for the study while the Product Moment Correlation technique was employed to test the study hypotheses. The result of the correlation coefficients shows that there is a positive correlation between firms' critical decisions, namely, CEO Compensation, CEO Tenure, Debt Intensity, Unrelated Diversification, Intensity of Expenditure on Research and Development and boards dominated by non-executive directors. Based on this positive result, it was recommended that government should enforce the recommendations of Code of Corporate Governance that stipulated a higher proportion of non-executive directors in a firm board of directors.

Keywords: Board composition, Firm Critical Decision, Corporate Governance, Firm Performance

INTRODUCTION

Corporate scandals in different countries such as Enron, WorldCom, Tyco International in the United States, HIH Insurance in Australia, Paramalat in Italy have highlighted the inadequate role played by the boards and the failure of corporate governance processes (France and Carney, 2002; Bosner and Fisher, 2007, Byron, 2007). The scandals elicited serious public interest on the role of the board, and the consciousness of how to make corporate boards effective. Most countries responded to this by introducing corporate governance codes. Banks, in particular, were brought to the fore because of the domino effect of bank failure in an economy.

The Securities and Exchange Commission in Nigeria (SEC), in keeping with her mandates of promoting good corporate governance in Nigeria and also complying with the global trend, recommended Code of Corporate Governance for quoted firms in Nigeria in 2003. The code made strong recommendations for the separation of the position of the CEO and the board chair, and the dominance of outside directors, among others for quoted firms in Nigeria. The recommendations are geared towards resolving the principal-agency problem which is grounded in the agency theory. Agency theory begins with the fact that many corporate managers are not owners but agents of owners, contracted to manage the company on their behalf. Since they are not direct owners but managers, and thus have less personal wealth at stake, their natural pursuit of self-interest could result in them taking riskier or even dishonest actions, which could bring harm to the firm or its owners (Jensen and Meckling, 1976). Agency problem arises whenever managers have incentives to pursue self-interest (self-serving behaviour) at the expense of shareholders. Most studies on corporate governance focused on how to effectively monitor the agents (resolving the conflict) against self-serving behaviour in order to protect shareholders interest.

Although it should be conceded that resolving the principal-agent problem is an important issue in the corporate governance of firms, the recent global financial crisis of 2007/08 has exposed other form of weaknesses in firms' corporate governance systems, particularly their critical decisions. It has been argued that some corporate boards lacked independence; directors often failed to make meaningful contributions to safeguard the growth and development of the firms. This raises an important question of whether the insufficient representation of outside directors is the possible explanation of boards' failure to fulfill their monitoring role in the manufacturing industry.

To test empirically whether board composition matters, one stream of research has examined the impact of board composition on firm performance, but with mixed and inconclusive results (Forbes and Miliken, 1999; Huse, 2000.; Johnson, et al., 1996; and Pettigrew, 1992). Another stream of research suggests that, rather than examining a board's monitoring effectiveness by using the firm financial performance as proxy, a more accurate evaluation can be gained by examining discrete decisions that involve a potential conflict of interest between management and shareholders (Deutsch, 2005). Deutsch (2005) argue that "[t]he rationale behind this line of inquiry is that whereas board monitoring has a direct effects on firms' critical decisions, it has an only an indirect effect on firm performance" (p.35). He further argues that firm performance is influenced by a multitude of endogenous and exogenous factors beyond the composition of its board.

To add to the debate, this paper examined the impact of board composition on the critical decisions of Nigerian firms. The motivation for this study is two folds. First, the subject of corporate governance from empirical standpoint has suffered neglect both in the academia and public policy in Nigeria. The apparent neglect of corporate governance in Nigeria public policy is perhaps a reflection of the paucity of empirical works in this area. Second, the Securities and Exchange Commission of Nigeria's Code of Corporate Governance for quoted firms in Nigeria (2003), view board composition from the prison of effective monitoring. The study will provide a better insight on accurate monitoring mechanisms that involve a potential conflict of interest between management and shareholders.

The rest of the paper is arranged as follows: review of related literature on board composition and firm critical decisions; methodology adopted in processing the data generated for the study; presents and discusses the result of the empirical analysis and finally summaries and concludes the paper.

REVIEW OF LITERATURE

Board Composition and Firm Critical Decisions

Corporations are both work sharing and risk sharing entities (Eisenhardt, 1985). Organized production involves parties who are responsible for formulating and implementing strategies and parties who contribute capital and are willing to bear the risk of losses (Alchain and Demestz, 1972; Fama and Jensen, 1983a; Jensen and Meckling, 1976). Risk bearing is necessary because when strategies and assets are deployed, it is not known whether the difference between stochastic cash flows and obligated production and distribution cost will be positive, negative or zero. Although this so-called residual risk is

experienced in all types of organizations, organizational forms may be differentiated on the basis of how risks are allocated among their constituents.

In large corporations, shareholders purchase and hold equity shares which, in return for bearing residual risk, entitle them to positive residuals generated by the production and sale of output. In contrast, those who manage these firms usually receive fixed salaries plus bonus incentives tied to performance measures (Goodstein, Gautam, and Bocker, 1994). The large, open corporations are thus distinguished from other organizations (e.g. closed corporations and partnerships) through the nearly complete separation of decision management and residual risk bearing. Agency theory suggests that this so-called separation of ownership and control is economically efficient, despite the noted potential for conflicts of interest.

Board Composition

The board of directors and its relationship to firm performance have long been the focus of research (Forbes and Miliken, 1999; Huse, 2000; Johnson, et al., 1996; and Pettigrew, 1992). Several theories – most notably, agency, resource dependence and institutional theories – have been put forward to explain and predict the attributes of board and how these, in turn affect firm performance. The role of board of directors is to protect the interest of shareholders by monitoring a firm's management team. Monitoring involves ratifying major policy decisions and hiring, firing, and compensating a firm's top managers (Fama and Jensen, 1983). One factor that might affect the ability of the board to monitor a firm's manager is the board's composition (Fama, 1980; Fama and Jensen, 1983). A firm's board of directors is an important mechanism for limiting manager's self-serving behavior when the company's managers and owners have conflicting goals (Eisenhardt, 1989).

Again, board of directors play multiple and critical roles in organizations. Boards are primarily responsible for:

- Providing oversight, advice and counsel to CEOs and
- Monitoring and if necessary, disciplining CEOs.

While the former role has been the subject of as much research as the latter, the independence of the board of directors has been seen throughout as a centerpiece of effective corporate governance. As noted, board composition is a surrogate for board independence, or the extent to which a board is likely to dispassionately evaluate CEO. Moreover, independence implies a board is able and willing to provide guidance that does not necessarily mirror the will of CEO. Both historically and within the individual corporations, the separation of residual risk bearing from decision management lead to systems that separate decision management from decision control (Fama and Jensen, 1983b). That is, as firms grow large and management and ownership becomes specialized, conflicts of interest arise. These conflicts though give rise to the need to specialize further decision management (initiation and implementation) and decision control (ratification and monitoring) (Fama and Jensen, 1983). Decision management is naturally the responsibility of senior management, whereas decision control becomes the responsibility of the board of directors. Placing the responsibility for decision control with a board precludes managers from being the evaluators of their own performance, and thus, provides a safeguard to investigate managerial performance. Directors have the legal right to evaluate internal management and the board is believed to set the premise of management decision making. Some researchers question the efficacy of including inside directors in the decision control process. What purpose is served by giving managers a say in board deliberations? How can inside directors avoid conflicts of interest between loyalty to their superiors and the fiduciary obligations to shareholders? Clearly, the practice of including inside directors on the board seems inconsistent with the need to separate decision management from decision control. Yet a closer examination of this issue reveals that inside directors play an important role both in maintaining the separation of ownership and control in large corporations and preserving the efficiencies ascribed to this arrangement.

RESEARCH CONTEXT AND HYPOTHESES

Boards' Monitoring and Firms' Critical Decisions

A review of corporate governance literature reveals that a conflict of goals between a firm's CEO and its shareholder typically revolves around three main underlying issues: CEO compensation, risk to the firm

and corporate control. CEOs have been criticized for benefiting themselves by receiving excessive compensation (Loewenstein, 1994) which is often unrelated to the performance of the firm (Jensen and Murphy, 1990). Furthermore, because risk averse CEOs unlike shareholders, are unable to diversify their firms non-systematic risk, they have been criticized for adopting risk reduction strategies that are not optimal to shareholders (Amihud and Lev, 1981). Finally, managers who isolate themselves from the disciplinary force of the market for corporate control and resist being replaced have embodied perhaps the costliest manifestation of self-serving behaviour (Jensen & Ruback, 1983; Shleifer & Vishny, 1986).

Given that a boards governing role is oversight, it follows that a board's effectiveness will be manifested in the mitigation of self-serving behaviour by managers. It is therefore, not surprising that corporate governance research has used critical decisions in which there is a potential conflict of interest as proxies for monitoring effectiveness (Kosnik, 1987; Sundaramurthy, 1996). In these literatures, some critical decisions investigated by agency theory-based research as potential indicators of board's monitoring control, however is one of several critical board tasks, others include providing resources, expertise and counsel (Daily et al, 1999; Johnson et al, 1996; Pfeffer & Salancik, 1978; Zahra & Pearce, 1989). Interestingly, these multiple roles may neither be complementary nor tangible.

Inside directors (Executive directors) for example, are considered valuable for their service in the expertise-counsel role (e.g., Baysinger & Hoskisson, 1990; Hoskisson et al, 1991), but they are routinely criticized for their lack of independence from CEOs. Similarly affiliated directors (outside directors and non-executive directors with business of personal relationships with the firm) may be outstanding in a resource role but will also be criticized for their lack of independence.

These decisions embed potential conflict around issues of CEO compensation, risk to the firm, or corporate control. Although some decisions involve more than a single underlying issue, the following classification highlights the main underlying issue addressed in the literature regarding each decision. Decision about CEO compensation includes the level of CEO total compensation and the ratio of incentive payment of the total CEO compensation. Decisions that influence the firm's risk include unrelated diversification, research and development expenditure and debt intensity.

Board Composition and CEO Compensation

Consistent with agency theory, most corporate governance codes considers compensation committees to be a powerful monitoring mechanism. To protect shareholders from managerial self-interest, these codes as well as a number of other regulatory bodies have developed specific guidelines regarding compensation committee composition (e.g. Kesner, 1988; Kenser, 1994). The members of a firm's compensation committee should be independent directors who are not managers of the firm. These non-management committee members are expected to act as objective decision makers who will ensure that the CEO's compensation is set at appropriate levels (Bowen, 1994; Mangel & Singh, 1993; Singh & Harinto, 1989). Not all non-management directors perform equally well as effective stewards for shareholders (Jensen & Murphy, 1990). Non-management directors with personal and/or professional relationships with a firm or its management, for example, may be more likely to be subject to managerial influence. The issue is the extent to which these affiliations erode the ability or willingness of a director to exercise independent judgment in compensation decisions, challenging the CEO may place not only directors' board seats, but also valued personal and professional relationship, at risk.

Singh and Harianto (1989a) noted that CEOs may offer non-management directors attractive contracts and consulting agreements. Almost certainly, future relationships of this type will be jeopardized should directors fail to support the CEOs wishes where personal relationships constitute the basis for directors' affiliation; a sense of obligation to the CEOs may be even stronger (Fireman, 1990). In addition to the likelihood that director's personal or professional relationship with CEOs will result in higher CEO pay (Elson, 1993), it may also be more likely that affiliated directors will structure compensation packages that expose CEOs to less compensation-based risk. Contingent and non-contingent forms of pay, for example, expose executives to differing levels of risk. Compensation packages containing higher proportions of non-contingent pay expose executives to far less risk than packages largely comprised of contingent pay (e.g., Gomez-Mejia, 1994). Consistent with the focus of agency theory, it is generally

recommended that the compensation committee should be made of outside directors with no personal or professional ties to complicate their monitoring function.

Directors' appointment to board timing may also provide some insight into a CEO's ability to exert influence over compensation committee members in order to garner a more attractive compensation package. Non-management directors may feel a sense of divided loyalty as the attempt to fulfill the fiduciary duty to shareholders while maintaining an amiable relationship with the CEO under whose command they were appointed to a board (e.g. Boeker, 1992; Hill & Pham, 1991; Monks & Minow, 1991). CEOs are commonly consulted on director nomination decisions enabling them to create board of directors sympathetic to their viewpoints (e.g. Monks & Minow, 1991; O'Reilly et al, 1988; Wade et al, 1990). Directors appointed during the tenure of an incumbent CEO have been termed interdependent directors (e.g. Daily, 1995; Lambert et al, 1993; Sundaramurthy, 1996; Wade et al, 1990).

Elson (1993) noted that compensation is more likely to be excessive when directors feel as if they owe their board seats to executive privilege, as may be the case with independent directors. Westphal and Zajac (1994) for example, found that CEO compensation was higher when a CEO's tenure was greater than that of the chair of the compensation committee. Other researchers have noted that potential for conflicts of interest exist when members of management either individually or collectively possess some measure of influence over board of directors (e.g. Finkelstein, 1992; Ungson & Steiers, 1984; Westphal & Zajac, 1994). These findings, in concert, are consistent with the underlying assumptions of agency theory and with the idea that compensation is a function of the balance of influence and power in an organization (Fama, 1980; Finkelstein & Hambrick, 1988; Jesen & Meckling, 1976).

To the extent that directors feel some sense of loyalty to a CEO as a result of their nomination to the board under his or her command, they may be less likely to interject dissension into boardroom affairs. Dissension surrounding issues as potentially controversial as CEO pay almost certainly places dissenting directors at risk of losing management support during director re-nominations (Elson, 1993; Milliken & Martins, 1996). Perhaps, more importantly, personal and professional relationships may be jeopardized. Alternatively, directors may find ways to pacify shareholders while at the same time supporting the CEO. The presence of the CEOs of other firms on one firm's compensation committee may also enable the CEO of the focal firm to exert influence over the compensation process (e.g. Lorsch & MacIver, 1989). As Useem (1984) noted, corporate CEOs tend to be a relatively homogenous, cohesive collection of individuals. This cohesion may lead to a general propensity to support peer CEOs in board (Lorsch & MacIver, 1989; Mace, 1971). Consistent with Social Comparison Theory, CEOs of other firms serving on a focal firm's compensation committee may review and recommend a compensation package that is more consistent with their preferences as corporate leaders than with those of shareholders (O'Reilly et al, 1988).

O'Reilly and colleagues (1988) for example found that CEO compensation was highly related to the compensation of outside board members serving on compensation committees (see Main et al, 1995). Related research has found that CEOs are often compensated in relation to CEOs at comparison firms (Crystal, 1991; Finkelstein & Hambrick, 1988; Hambrick & Finkelstein, 1995). Hambrick and Finkelstein (1995) for example, found that in management-controlled firms, a 1 percent increase in CEO pay within their industry was associated with a 1.37 percent increase in the focal CEO's pay. Additionally, relying on the reciprocity principle, Westphal and Zajac (1997) found that the proportion of CEOs on a board was negatively related to an increase in compensation contingency.

Research on demographic similarity may also provide some context for examinations of the relationship between CEO and directors on compensation committees and CEO compensation. Demographic similarity provides an important basis for group membership (e.g., Tsui et al, 1992). The board of directors is arguably one of the more significant groups with which a CEO interacts. CEOs may prefer demographically similar board of directors and by extension, board committees whose members are more likely to support management initiatives. Westphal and Zajac (1995), for example, found that powerful CEOs tendency to appoint board members was associated with increases in CEO compensation as well as with decreases in performance contingent compensation. These findings may suggest that CEOs, who as

a group tend to have similar experiences and backgrounds will provide peer CEOs with very attractive compensation packages. We therefore, hypothesize:

Hypothesis 1: Boards dominated by Non-Executive (Outside) Directors are more likely to be dispassionate on matters concerning CEO compensation.

Board Composition and CEO Turnover

Shareholders have a clear interest in replacing a failing CEO. This move can achieve two goals. First, it can signal to the firm's image and help re-establish confidence in its future. Second, the replacement of a firm's CEO may, in effect, alter the firm's strategy, structures, and processes, which in turn may affect its performances (Wallace et al, 1990). CEOs, however, are likely to exercise whatever power they possess to maintain corporate control and its associated benefits (Brady & Helmich, 1984). Moreover, being fired from a failing firm damages the CEO's reputation and reduces his or her chances of being employed by other firms (Gilson, 1989 & 1990). Abnormal stock returns around the time a resignation is announced are consistent with the view that directors increase a firm's value by removing bad management (Weisbach, 2008). Because the dismissal of a CEO requires the exercise of power, a board's ability to oust the CEO is conditional on the independence that is characteristic of outside directors (Fredrickson et al., 2008). CEO turnover will be a proxy of the absolute value of the number of times any firm has changed its CEO. Again, we hypothesize thus:

Hypothesis 2: Boards dominated by Non-Executive Directors are more likely to fire a failing CEO

Board Composition and CEO Tenure

New CEOs confront significant challenges upon taking office. Promotion to the CEO position typically leads to significant changes in both an executive's responsibility and task environment (Kotler, 1982). New CEOs must adjust to their new roles and quickly develop good working relationships with the other members of their top management groups, boards of directors and powerful outside stakeholders (Vancil, 1987). The learning process is stressful and time consuming (Kotler, 1982). At the same time, new CEOs are charged with specific strategic mandates (Hambrick & Fukutomi, 1991), a charge that further increases the difficulty of their tasks. Finally, and perhaps most crucial for new CEOs, is their need to establish the authority in a top position (Gabarro, 1987).

Authority is legitimate power and is of two types – authorized power and endorsed power (Scott, 1995). Authorized power is granted by those superior to the power holder (Weber, 1946) and endorsed power is granted by those subordinate to the power holder. To establish their authority, new CEOs must be accepted by both the boards of directors and subordinate executives. Although the official appointment represents authorization by the board of directors, it does not necessarily confer endorsement from subordinates (Bernard, 1938; Selznick, 1957). Further, the authorization of a board is likely to be somewhat tentative and can be revoked quickly if directors develop significant concerns about a new CEO's leadership capacity (Vincil, 1987). Indeed, because there is little proof of accountability in office, the leadership capacity of new CEO's is under close scrutiny by outside directors (Alderfer, 1986). Thus, in unity they can prove their competence and then meet the expectations of both their boards and subordinate executives; the authority of new CEO's will be much weaker than that of established CEO (Hambrick & Fakutomi, 1991; Ocasio, 1994). The challenges facing new CEOs leave them vulnerable to power contests with rival executives. The fact that new CEOs need time to establish their authority in the top position (Selznick, 1957) provides an opportunity for ambitious senior executives to challenge them early in their tenures. Once incumbent CEOs have proven their leadership capacity and establish their authority in office, the chance for senior executives to successfully mount a challenger is greatly reduced (Ocasio, 1994; Markides, 1995). Thus, CEOs are likely to face a higher risk of power contests with senior executives in the early years of their tenures, and we expected to see a higher rate of CEO dismissal followed by inside succession during that period. Under this premise, we hypothesize:

Hypothesis 3: CEOs are less likely to face a higher risk of power contests with senior executives in the early years of their tenures in a board dominated by Non-Executive Directors.

Board Composition and Debt Intensity

Research that has examined the determinants of corporate borrowing has found that in the real world, firms rely more on internal funds and less on external funds than would be optimal, based on pure

economic criteria (Donaldson, 1969, 1990, cited by Mizruchi & Stearns, 1994). An important managerial consideration against increasing a firm's leverage by borrowing is the higher risk of bankruptcy (Grossman & Hart, 1982). Bankruptcy may not only lead to the dismissal of the CEO (Wagner, Pfeller & O'Reilly, 1984) but may also damage the CEO's prospects for future employment (Gilson, 1989, 1990). Myers (1984) argued that suboptimal levels of external financing could also be explained by the subsequent reduction in managerial autonomy. Because financial institutions often exercise power over the firms they lend to, managers tend to prefer to use external capital rather than rely on external funds. Moreover, where a firm defaults on payment, control rights are often transferred to large creditors (Agrawal & Knoeber, 1996), thus reducing a CEO's power. In summary, it is impractical to expect managers to voluntarily increase the firm's leverage which increases the firm's risk and restricts their discretion and control. It should therefore, be expected that vigilant board monitoring would result in higher debt levels. We hypothesize:

Hypothesis 4: Boards dominated by Non-Executive Directors are more likely to increase the debt intensity of the firm.

Board Composition and Unrelated Diversification

Unrelated diversification, whereby a firm moves into areas unrelated to its current offerings, reduces the non-systemic risk of firms. Whereas shareholders can diversify non-systematic risk more efficiently through the stock market than through diversification, CEOs often use this strategy to diversify their employment risk (Amihud & Lev, 1981), to serve the aspirations for empire building (Benston, 1985; Myers, 1983) and to receive the higher compensation associated with managing a larger firm (Tosi & Gomez-Mejia, 1989). Several researchers argue that both managers and shareholders have a concern with a firm's non-systematic risk. Reducing a firm's non-systematic risk serves shareholders interest because high risk may discourage stakeholders essential to a firm's success from establishing working relationships with the firm (Lane et al., 1998). Yet, unrelated diversification is among the most commonly cited managerial, as opposed to shareholders objectives (Shleifer & Vishny, 1997).

Evidence supports the argument that unrelated diversification has a harmful effect on shareholders' wealth. Bidders' returns on acquisitions are often negative, and unrelated diversification often has an adverse effect on a firm's value (Jensen, 1986; Kaplan & Weishbach, 1992). Various studies demonstrate unambiguously that diversified firms trade at a discount relative to non-diversified firms in the industries (Berger & Ofek, 1995; Lang & Stulz, 1994). Although it has been recently argued that the discount associated with diversifications may often be overestimated, this does not imply that there is no agency cost associated with diversified firms (Campa & Kedia, 2002). Moreover, the results of recent studies examining the impact of CEO's ownership on firm diversification reinforce the view that diversification is often a result of agency problems – companies with a greater concentration of CEO ownership were less diversified (Amihud & Lev, 1999; Denis et al., 1999). According to agency theory, then, boards with a higher representation of outside directors are expected to restrain managers' self-serving behaviour by limiting the firms' level of unrelated diversification. The total number of a company subsidiary will be used as proxy for firm unrelated diversification. We therefore, hypothesize:

Hypothesis 5: Boards dominated by Non-Executive Directors are more likely to restrain firm from unrelated diversification

Research and Development Expenditure

Research and development investments are inherently risky (Baysinger et al., 1991; Graves and Langowitz, 1993), with a high probability of failure (Finkelstein & Boyd, 1998). Investment in research and development also involves a temporal trade-off in which to some extent, the firm sacrifices short term financial performance for long-term performance gains (Laverty, 1996). In the long term, research and development investment can be expected to improve the performance of products and services, to facilitate learning, and to improve firms' capacity to absorb from their government the knowledge they need for future innovation (Cohen & Levinthal, 1990). However, the payoffs of successful research and development investments are only appreciated in the long run whereas in the short run, such investment can adversely affect financial performance (David et al., 2001).

Managers and shareholders have conflicting interest regarding research and development expenditures because they differ both in their attitudes toward risk and in their temporal preferences (David et al., 2001). Shareholders usually favour investment in research and development because they are able to diversify inherent research and development risk by holding share of multiple firms (Hansen & Hill, 1991) and because it can increase a firm's value. In contrast, managers are often preoccupied with safety, which leads them to under-invest in long-term, risky projects (Hirshleifer & Thakor, 1992). The increasing mobility of managers further motivates them to under-invest in research and development because the long term effects of this strategy might only be manifested after they have left the firm (Rumelt, 1987).

A short term increase in financial performance, in contrast, is realized immediately, enabling managers to demonstrate superior ability to the job market (Campbell & Marino, 1994) and more rapidly enhance their reputations (Narayanan, 1985). Because managers may serve their own interests at the expense of shareholder wealth by skewing research and development expenditure lower, we would expect more vigilant board monitoring to result in firms making higher research and development expenditures. Total amount of expenditure on research and development will be used as proxy for research and development expenditure.

Using a sample of research and development-intensive firms, Hill and Snell (1988) also reported a significant negative relation between outside director dominance and the intensity of the research and development. They suggested that this is the opposite of what would be expected if outsiders acted as guardians of the stockholders' welfare in a research-intensive environment. Along the lines of Lawrence and Lorsch's (1967) research, Hill and Snell suggested that because innovation brings more insiders onto the board in an attempt to integrate the functional activities of the firm around its strategy" Complementary to this idea is that inside directors safeguard the interests of management, which is especially important in highly uncertain environments.

Research and development-intensive firms are continually subjected to technological uncertainty. For example, a leading pharmaceutical firm never knows when a competitor will discover a new drug that will displace its dominant product. Thus, while returns may be higher for such firms, corporate level managers may be unwilling to provide impetus to research and development initiatives because of the greater residual risk. This problem may be overcome by including inside directors as important players in the decision-control process. Managers who are evaluated by strategic controls are likely to assign higher utility values to the uncertain cash-flows associated with positive spending decisions for research and development. Managers in research and development-intensive firms especially prefer this control because they have to bear more of the consequences of technological obsolescence than do shareholders who can diversify their risk.

Therefore, managers should be more likely to support research and development initiatives generated at the operational level when insiders have an important place in making control decisions because through such processes insiders are better able to differentiate between decisions and risks. Thus, Hill and Snell's (1988) results are consistent with the notion that insider-dominated boards tend to preserve the separation of ownership and control. Of course, strategic controls may provide greater opportunity for managerial opportunism. Despite this, shareholders of firms that compete in R&D intensive industries may tacitly accept an emphasis on strategic control because of the high risk of technological mugging (Bedard & Johnson, 2004; Park et al., 2006). On balance, then, strategic controls are congruent with the dominance of R&D spending as a critical success factor (Oxelheim & Randoy, 2005; Hoskisson & Hitt, 1988). Hill and Snell's (1988) finding that the intensity of R&D is diminished in firms in which outsiders dominate the decision-control process is consistent with this notion. To this end, we hypothesize:

Hypothesis 6: Board dominated by Non-Executive Directors will more likely increase the intensity of expenditure on research and development.

METHODOLOGY

Nature of Data and Population of Study

The data for the study is drawn from primary survey through the administration of questionnaire to directors of manufacturing firms listed on the Nigerian Stock Exchange (NSE). The NSE Index consists of the top 212 manufacturing firms listed on the Nigerian Stock Exchange as at December, 2012. The NSE Index accounts for approximately 90 percent of the Exchange in terms of market capitalization and all share index.

Given that the Code of Corporate Governance which stipulated the separation of the position of the Board Chairman from that of the Chief Executive Officer came into effect in 2006, the study period covers December 2005 to December 2012. Our sample excludes firms that were liquidated and delisted from the Nigerian Stock Exchange within the period. We also excluded firms from which we could not get complete data, leaving us with a final sample of 117 firms observed over seven years. For each of the firms, questionnaires were issued to Executive and Non-Executive Directors.

According to the Security and Exchange Commission (SEC) Code of Corporate Governance in Nigeria recommendation (2003), the recommended maximum board size for Nigerian firms is 15 and a minimum of 5. In line with the recommendation, the total board size for the study is (15*117), given a total of 1,755. To ensure even representation across the different sectors of the Nigerian manufacturing industry, the purposive and multi-stage sampling technique was used to draw a sample of 504 used for the study.

Validity and Reliability of Research Instrument

The questionnaire was closely scrutinized by two experts in evaluation and measurement in terms of language, relevance and coverage of the topic to ensure validity while the Pearson Product Moment Correlation was used to determine reliability. This method involves examining the correlation between responses of Executive and Non-Executive Directors of firms in Nigeria from a pilot observation of responses from the two groups of respondents. A correlation above 0.5 indicates reliability while a correlation coefficient below 0.5 indicates no reliability.

Table 1 – Reliability Test

Model	R	R-Square	Adjusted R-Square	Std Error of the Estimate
1	0.878 ^a	0.855	0.813	0.8213

Source: Computed by the Study using SPSS software

Analytical Model

The research hypotheses will be tested using bivariate correlation technique. Correlation is a bivariate analysis that measures the strengths of association between two variables (Algina & Keselman, 1999). The value of the correlation coefficient varies between +1 and -1. When the value of the correlation coefficient lies around ± 1, then it is said to be a perfect degree of association between the two variables. As the correlation coefficient value goes towards 0, the relationship between the two variables will be weaker.

In this study, we adopt the Pearson correlation technique. Pearson r correlation is widely used in statistics to measure the degree of the relationship between linear related variables. Pearson r correlation is used to measure the degree of relationship between the two commodities. The following formula is used to calculate the Pearson r correlation (Shieh, 2006).

$$r = \frac{N \sum xy - \sum (x)(y)}{\sqrt{N \sum x^2 - \sum (x^2)} [N \sum y^2 - \sum (y^2)]}$$

Where:

- r = Pearson r correlation coefficient
- N = number of value in each data set
- ∑xy = sum of the products of paired scores
- ∑x = sum of x scores
- ∑y = sum of y scores

$\sum x^2$ = sum of squared x scores
 $\sum y^2$ = sum of squared y scores

DATA PRESENTATION AND ANALYSIS

Data for the study are presented in line with the objectives of the study.

Table 2 - Boards dominated by Non-Executive Directors are more likely to be dispassionate on matters concerning CEO's compensation

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Strongly Agree	88	17.5	17.5	17.5
Agree	270	53.6	53.6	71.1
Undecided	65	12.9	12.9	84.0
Disagree	62	12.3	12.3	96.3
Strongly Disagree	19	3.7	3.7	100
Total	504	100	100	

Source: Field Data, 2015 (computed with SPSS software)

Table 2 shows the descriptive statistics of the effect of non-executive dominated board on CEO's total compensation. The result shows that 88 or approximately 18 percent of the respondents strongly agree that boards dominated by non-executive directors are more likely to be dispassionate on matters concerning CEO's compensation while 270 or approximately 54 percent of the respondents agree. However, 62 or 12.3 percent of the respondents disagree while 19 or approximately 4 percent of the respondents strongly disagree. The implication of this finding is that boards dominated by non-executive directors are more likely to be dispassionate on matters concerning CEO's compensation

Table 3 – Boards dominated by Non-Executive Directors are more likely to fire a failing CEO than Board dominated by Executive Directors

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Strongly Agree	89	17.7	17.7	17.7
Agree	234	46.4	46.4	64.1
Undecided	76	15.1	15.1	79.2
Disagree	42	8.3	8.3	87.5
Strongly Disagree	63	12.5	12.5	100
Total	504	100	100	

Source: Field Data, 2015 (computed with SPSS software)

Table 3 shows that 89 or approximately 18 percent of the respondents strongly agree that boards dominated by non-executive directors are more likely to fire a failing CEO than board dominated by executive directors. 234 or 46.4 percent agree with this while 76 or approximately 15 percent of the respondents were undecided on the matter. 42 of the respondents however, disagree while approximately 13 percent of the respondents strongly disagree. We can infer from the result that boards dominated by non-executive directors are more likely to fire a failing CEO than board dominated by executive directors.

Table 4 - CEOs are less likely to face a higher risk of power contests with senior executives in the early years of their tenures in a board dominated by Non-Executive Directors

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Strongly Agree	115	22.8	22.8	22.8
Agree	340	67.5	67.5	90.3
Undecided	0	0	0	90.3
Disagree	40	7.9	7.9	98.2
Strongly Disagree	9	1.8	1.8	100
Total	504	100	100	

Source: Field Data, 2015 (computed with SPSS software)

Result from Table 4 shows that 115 or approximately 23 percent of the respondents strongly agree that CEOs are less likely to face a higher risk of power contests with senior executives in the early years of their tenures in a board dominated by Non-Executive Directors. This notion was shared by 340 or nearly 68 percent of the respondents. However, 40 or nearly 8 percent of the respondents disagree that CEOs are less likely to face a higher risk of power contests with senior executives in the early years of their tenures in a board dominated by Non-Executive Directors. Again, approximately 2 percent strongly disagree that CEOs are less likely to face a higher risk of power contests with senior executives in the early years of their tenures in a board dominated by Non-Executive Directors. We can infer from the result that CEOs are less likely to face a higher risk of power contests with senior executives in the early years of their tenures in a board dominated by Non-Executive Directors.

Table 5 – Boards dominated by Non-Executive Directors are more likely to increase debt intensity of the firm

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Strongly Agree	132	26.2	26.2	26.2
Agree	240	47.6	47.6	73.8
Undecided	34	6.8	6.8	80.6
Disagree	58	11.5	11.5	92.1
Strongly Disagree	40	7.9	7.9	100
Total	504	100	100	

Source: Field Data, 2015 (computed with SPSS software)

Table 5 shows that 132 or 26.2 percent of the respondents strongly agree that boards dominated by non-executive directors are more likely to increase the debt intensity of manufacturing firms in Nigeria. 240 or approximately 48 percent of the respondents agree with this assertion.. However, 34 or nearly 7 percent of the respondents were undecided on the subject while nearly 12 percent of the respondents disagree. 40 or nearly 8 percent of the respondents strongly disagree that boards dominated by non-executive directors are more likely to increase the debt intensity of manufacturing firms in Nigeria. The implication of this finding is boards dominated by non-executive directors are more likely to increase the debt intensity of manufacturing firms in Nigeria.

Table 6 - Boards dominated by Non-Executive Directors are more likely to restrain firms from unrelated diversification

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid Strongly Agree	65	12.9	12.9	12.9
Agree	376	74.6	74.6	87.5
Undecided	22	4.4	4.4	91.9
Disagree	32	6.3	6.3	98.2
Strongly Disagree	9	1.8	1.8	100
Total	504	100	100	

Source: Field Data, 2015 (computed with SPSS software)

Table 6 shows that 65 or nearly 13 percent of the respondents strongly agree that boards dominated by non-executive directors are more likely to restrain firms from unrelated diversification. 376 or approximately 75 percent of the respondents agree with this. However, 22 or 4.4 percent of the respondents were undecided while 32 or 6.3 percent of the respondents disagree. 9 or approximately 2 percent of the respondents strongly disagree that boards dominated by non-executive directors are more likely to restrain firms from unrelated diversification. We can infer from this finding that boards dominated by non-executive directors are more likely to restrain firms from unrelated diversification.

Table 7 - Board dominated by Non-Executive Directors will more likely increase the intensity of expenditure on research and development

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Agree	133	26.4	26.4
	Agree	244	48.4	74.8
	Undecided	86	17.1	91.9
	Disagree	31	6.1	98.0
	Strongly Disagree	10	2.0	100
	Total	504	100	100

Source: Field Data, 2015 (computed with SPSS software)

Table 7 shows that 26.4 percent of the respondents strongly agree that board dominated by non-executive directors will more likely increase the intensity of expenditure on research and development. 244 or 48.4 percent of the respondents agree with this also while approximately 17 percent of the respondents were undecided. However, approximately 6 and 2 percent disagree and strongly disagree respectively that board dominated by non-executive directors will more likely increase the intensity of expenditure on research and development. We can infer from this finding that board dominated by non-executive directors will more likely increase the intensity of expenditure on research and development.

Test of the Research Hypotheses

The foregoing descriptive statistics were further tested using inferential statistics to determine the possible significance of those responses at 95 % level of significance and five degree of freedom. The six hypotheses were tested using Pearson Moment Correlation Coefficient built into the SPSS computer software.

Hypothesis 1: Boards dominated by Non-Executive (Outside) Directors are more likely to be dispassionate on matters concerning CEO compensation.

Decision Rule: The decision rule on the r coefficient is to reject the null hypothesis and accept the alternative hypothesis if the critical value of the r coefficient is less than the computed r coefficient and accept the null if otherwise.

The mean responses and the standard deviations for the question in Table 2 is considered relevant for testing hypothesis one. The Pearson Product Moment Correlation coefficient is presented below:

Pearson Product Moment Correlations for Hypothesis 1

Correlations

		CEO Compensation	Non-Executive Directors
CEO Compensation	Pearson Correlation	1	.799 **
	Sig. (2-tailed)		.000
	N	504	504
Non-Executive Directors	Pearson Correlation	.799 **	1
	Sig. (2-tailed)	.000	
	N	504	504

** . Correlation is significant at the 0.01 level (2-tailed).

From the above computed estimation, the calculated correlation coefficient is 79.9. This is greater than the critical table value of 9.925 at 90% confidence level. Therefore, the null hypothesis is rejected, and alternative hypothesis accepted accordingly. This result is significant as asymp. Sig is 0.000 < 0.05. Hence, Boards dominated by Non-Executive (Outside) Directors are more likely to be dispassionate on matters concerning CEO compensation.

Hypothesis 2: Boards dominated by Non-Executive Directors are more likely to fire a failing CEO

The mean responses and the standard deviations for the question in Table 3 is considered relevant for testing hypothesis two. The Pearson Product Moment Correlation coefficient is presented below:

Pearson Product Moment Correlations for Hypothesis 2

Correlations

		Firing a Failing CEO	Non-Exe Directors
Firing a failing CEO	Pearson Correlation	1	.516 **
	Sig. (2-tailed)		.000
	N	504	504
Non-Executive Directors	Pearson Correlation	.516 **	1
	Sig. (2-tailed)	.000	
	N	504	504

** . Correlation is significant at the 0.01 level (2-tailed).

From the above computed estimation, the calculated correlation coefficient is 51.6. This is greater than the critical table value of 9.925 at 90% confidence level. Therefore, the null hypothesis is rejected, and alternative hypothesis accepted accordingly. This result is significant as asymp. Sig is 0.000 < 0.05. Therefore, we accept that Boards dominated by Non-Executive Directors are more likely to fire a failing CEO.

Hypothesis 3: CEOs are less likely to face a higher risk of power contests with senior executives in the early years of their tenures in a board dominated by Non-Executive Directors.

The mean responses and the standard deviations for the question in Table 4 is considered relevant for testing hypothesis three. The Pearson Product Moment Correlation coefficient is presented below:

Pearson Product Moment Correlations for Hypothesis 3

Correlations

		Power Contest	Non-Exe Directors
Power Contest	Pearson Correlation	1	.592 **
	Sig. (2-tailed)		.000
	N	504	504
Non-Executive Directors	Pearson Correlation	.592 **	1
	Sig. (2-tailed)	.000	
	N	504	504

** . Correlation is significant at the 0.01 level (2-tailed).

From the above computed estimation, the calculated correlation coefficient is 59.2. This is greater than the critical table value of 9.925 at 90% confidence level. Therefore, the null hypothesis is rejected, and alternative hypothesis accepted accordingly. This result is significant as asymp. Sig is 0.000 < 0.05. Hence, we accept the fact that CEOs are less likely to face a higher risk of power contests with senior executives in the early years of their tenures in a board dominated by Non-Executive Directors.

Hypothesis 4: Boards dominated by Non-Executive Directors are more likely to increase the debt intensity of the firm.

The mean responses and the standard deviations for the question in Table 5 is considered relevant for testing hypothesis four. The Pearson Product Moment Correlation coefficient is presented below:

Pearson Product Moment Correlation for Hypothesis 4

Correlations

		Debt Intensity	Non-Executive Directors
Debt Intensity	Pearson Correlation	1	.760 **
	Sig. (2-tailed)		.000
	N	224	224
Non-Executive Directors	Pearson Correlation	.760 **	1
	Sig. (2-tailed)	.000	
	N	224	224

** . Correlation is significant at the 0.01 level (2-tailed).

From the above computed estimation, the calculated correlation coefficient is 76.0. This is greater than the critical table value of 9.925 at 90% confidence level. Therefore, the null hypothesis is rejected, and alternative hypothesis accepted accordingly. This result is significant as asymp. Sig is 0.000 < 0.05. Hence, we conclude that Boards dominated by Non-Executive Directors are more likely to increase the debt intensity of the firm.

Hypothesis 5: Boards dominated by Non-Executive Directors are more likely to restrain firms from unrelated diversification

The mean responses and the standard deviations for the question in Table 6 is considered relevant for testing hypothesis five. The Pearson Product Moment Correlation coefficient is presented below:

Pearson Product Moment Correlation for Hypothesis 5

Correlations

		Unrelated Diversification	Non-Executive Directors
Unrelated Diversification	Pearson Correlation	1	.240 **
	Sig. (2-tailed)		.000
	N	504	504
Non-Executive Directors	Pearson Correlation	.240 **	1
	Sig. (2-tailed)	.000	
	N	504	504

** . Correlation is significant at the 0.01 level (2-tailed).

From the above computed estimation, the calculated correlation coefficient is 24.0. This is greater than the critical table value of 9.925 at 90% confidence level. Therefore, the null hypothesis is rejected, and alternative hypothesis accepted accordingly. This result is significant as asymp. Sig is 0.000 < 0.05. We therefore conclude that Boards dominated by Non-Executive Directors are more likely to restrain firms from unrelated diversification.

Hypothesis 6: Board dominated by Non-Executive Directors will more likely increase the intensity of expenditure on research and development.

The mean responses and the standard deviations for the question in Table 7 is considered relevant for testing hypothesis six. The Pearson Product Moment Correlation coefficient is presented below:

Pearson Product Moment Correlation for Hypothesis 6

Correlations

		Research & Development	Non-Executive Directors
Research & Development	Pearson Correlation	1	.180 **
	Sig. (2-tailed)		.000
	N	504	504
Non-Executive Directors	Pearson Correlation	.180 **	1
	Sig. (2-tailed)	.000	
	N	504	504

** . Correlation is significant at the 0.01 level (2-tailed).

From the above computed estimation, the calculated correlation coefficient is 18.0. This is greater than the critical table value of 9.925 at 90% confidence level. Therefore, the null hypothesis is rejected, and alternative hypothesis accepted accordingly. This result is significant as *asymp. Sig* is 0.000 < 0.05. We therefore conclude that Boards dominated by Non-Executive Directors will more likely increase the intensity of expenditure on research and development.

DISCUSSION

It has been argued that though resolving the principal-agent problem is an important issue in the corporate governance of firms, the global economic and financial crisis of 2007/08 exposed other form of weaknesses in firms’ corporate governance systems, particularly their critical decisions. It has been argued that some corporate boards lacked independence; directors often failed to make meaningful contributions to safeguard the growth and development of the firms. This raises an important question of whether the insufficient representation of outside directors is the possible explanation of boards’ failure to fulfill their monitoring role in the manufacturing industry. To test empirically whether board composition matters, one stream of research has examined the impact of board composition on firm performance, but with mixed and inconclusive results (Forbes and Miliken, 1999; Huse, 2000; Johnson, et al., 1996; and Pettigrew, 1992). Another stream of research suggests that, rather than examining a board’s monitoring effectiveness by using the firm financial performance as proxy, a more accurate evaluation can be gained by examining discrete decisions that involve a potential conflict of interest between management and shareholders (Deutsch, 2005). Deutsch (2005) argue that “[t]he rationale behind this line of inquiry is that whereas board monitoring has a direct effects on firms’ critical decisions, it has an only an indirect effect on firm performance” (p.35). Following Deutsch’s view, we have studied in this paper, at firm-level, the effect of board composition on critical decisions of firms in Nigeria.

This study thus provides empirical support for the institutional perspective at firm level for the predominant of non-executive directors in critical board decisions that could influence firm’s performance positively. Drawing on a framework that is largely informed by agency theory, demonstrating the effect of board composition on critical firm decisions, the six hypotheses of the study were all supported.

First, our findings show that in Nigerian firms, corporate boards dominated by non-executive directors are more likely to be dispassionate on matters concerning CEO compensation. This finding is consistent with Singh and Harrinto (1989); Mangel and Singh (1993) and Bowen (1994).

Second, we find evidence that boards dominated by non-executive directors are more likely to fire a failing CEO in Nigerian firms. Thus, we support the notion that failing CEO’s will not find comfort in a board dominated by non-executive directors as would have been the case in a board dominated by executive directors. This finding is consistent with Brady and Helmich (1984), Weisbach (1988), Wallance et al (1990) and Fredrickson et al (2008).

Third, we found that CEOs are less likely to face a higher risk of power contests with senior executives in the early years of their tenures in a board dominated by non-executive directors. This finding is

consistent with result of previous studies especially with Hambrick and Fakutomi (1991), Ocasio (1994) and Markides (1995).

Fourth, we found that firms in Nigeria with higher proportion of non-executive directors are more likely to increase the debt intensity of the firms than those firms that have higher number of executive directors on their boards. The context of this finding is that firms in Nigeria like other firms in developing economies prefer internal funding to external funding due to high cost of external funding and the corporate discipline that they might be subjected to in the case of external borrowing. This risk-averse disposition could prevent the firms from exploiting various opportunities that abound beyond the reach of their internal finances. This finding of the study is consistent with Wagner, Pfeller and O'Reilly (1994), Agrawal and Knoeber (1996) and Mizrruchi and Stearns (1998).

Fifth, the study found that firms in Nigeria with higher proportion of non-executive directors are more likely to restrain from unrelated diversification. In other words, higher numbers of non-executive directors in the board is positively related with unrelated diversification in the firm investment activities. This finding is in tandem with Lang and Stulz (1994), Berger and Ofek (1995), Denis et al (1999) and Campa and Kedia (2002).

Finally, the study found that firms with higher number of non-executive directors on the board will more likely increase the intensity of expenditure on research and development. This is consistent with a prior expectation and confirms results of earlier works, for example, Hoskisson and Hill (1988), Hill and Snell (1989) and Oxelheim and Randov (2005).

From the foregoing, this study enriches an understanding to the nagging question of whether the insufficient representation of outside directors is the possible explanation of boards' failure to fulfill their monitoring role in the manufacturing industry in Nigeria. The study has largely supported the thesis canvassed by Deutsch (2005) that rather than examining a board's monitoring effectiveness by using the firm financial performance as proxy, a more accurate evaluation can be gained by examining discrete decisions that involve a potential conflict of interest between management and shareholders. The central argument in this direction is that whereas board monitoring has a direct effects on firms' critical decisions, it has an only an indirect effect on firm performance.

CONCLUSION

The findings of the study has therefore, provided an empirical basis for this argument in Nigeria and the recommendations by the Securities and Exchange Commission in Nigeria that boards of Nigerian firms should have a higher proportion of non-executive directors in its membership.

The policy implication of the study is that the regulatory authorities in Nigeria should enforce the recommendations of the Code of Corporate Governance issued by the Securities and Exchange Commission in 2003 to the effect that non-executive directors should constitute a higher proportion of membership of board of directors of all quoted firms in Nigeria.

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