

# The Effectiveness of Boards of Directors of State Owned Enterprises in Developing Countries

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## Abstract

This paper aims to shed some new light on the conditions needed to ensure the effectiveness of Boards of Directors of state owned enterprises with a focus on infrastructure sectors. In the case of developing countries, empirical studies have found evidence of positive links between the composition of the Board of Directors and financial performance. Yet the lack of solid theoretical foundations, and in some cases poor data availability, makes the conclusions of most studies weak. Several policy recommendations emerge from the review of the economic literature and evidence from case studies. First, the introduction of a sufficient number of independent directors emerges as an important corporate governance

milestone. Empowering them to exercise effective monitoring of management, however, may prove to be a formidable challenge for of state owned enterprises. More attention to board procedures, particularly related to the Board selection and evaluation process, is essential, to produce the necessary insulation of Boards from government interference. Ensuring sufficient continuity of services to directors is particularly crucial to improve corporate governance. In addition, other factors that may reduce directors' ability to monitor corporate activities, such as the age profile and the number of Boards on which they sit, need to be handled more carefully.

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This paper—a product of the Sustainable Development Network (SDN)—is part of a larger effort in the Bank to improve our knowledge on alternative models to enhance the performance of infrastructure service providers, when full privatization is out of the realm of possibilities. Policy Research Working Papers are also posted on the Web at <http://econ.worldbank.org>. The author may be contacted at [mvagliasindi@worldbank.org](mailto:mvagliasindi@worldbank.org).

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# The Effectiveness of Boards of Directors of State Owned Enterprises in Developing Countries\*

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## **1. Introduction**

The aim of this paper is to shed some new light on the conditions needed to ensure the effectiveness of Boards of Directors of State Owned Enterprise (SOE) in infrastructure sectors. Despite the extensive empirical literature in this area (at least for developed countries), there are very few Board specific theoretical models. Most empirical work on the links between Board structures or other aspects of corporate governance and firm performance faces a set of empirical challenges, which make identification difficult. Because of these challenges, one could argue that we still know very little about the effects of Board structures and procedures on SOE performance, particularly for developing countries.

This paper reviews the economic literature and evidence from econometric analysis and case studies. From this review, it appears that independence is one of the most analyzed characteristic of the Board. Little attention has been paid to Board procedures, particularly related to the Board member selection and evaluation process. This may be due to the fact that most studies focused on a subset of listed private enterprises, for which compliance with procedural rules can be taken for granted. SOEs in developing countries are, in many cases, characterized by the lack of respect of formal rules and frequent political interference from the government. Introducing independent directors may not produce tangible results, if, for instance, formal procedures are not in place to produce the necessary insulation of Boards from governmental interference. Ensuring continuity of services to directors and limiting the number of Boards on which directors can sit may also be important to make Boards work effectively.

The structure of the paper is as follows. Section 2 reports the most common Board requirements imposed by company bylaws and capital market listing rules, highlighting the implementation challenges for SOEs in developing countries. Section 3 focuses on the composition of the Board, paying particular attention to the mechanisms that could be used to reinforce independence. Section 4 considers Board procedural rules, such as the selection, training and evaluation of directors. Section 5 reviews the theoretical research on Boards of Directors, considering the specific challenges posed by SOEs. Sections 6 and 7 review the empirical evidence of the links between corporate governance and performance at the enterprise and country levels, respectively. Section 8 concludes.

## **2. Board Requirements**

Most company bylaws and capital market listing rules (for the issuance of bonds or shares) require utilities to have a Board of Directors. The primary task of the Board is to ensure that management is acting in the interests of the shareholders, through an advisory and monitoring role. Frequently, regulations stipulate several conditions related to the number of directors, such as their type (e.g. executive, non-executive and independent directors) and skills of the appointees. Regulations may also contain additional formal requirements, such as frequency of meetings of the Board as a whole and/or the number and nature of Board committees. More recently, requirements on the selection and evaluation of the Board as a whole and individual directors, and restrictions on

factors such as age and number of Boards in which directors sit are also recommended in the corporate governance codes either at the country or the company levels.

Which ones of this long list of requirements matter most for ensuring the effectiveness of Boards for SOEs in developing countries? Transforming an SOE, previously run as a government department, into a corporation under the company law poses formidable challenges, but present several potential opportunities. Corporatization brings about insulation, because, almost universally, company laws limit the right of shareholders to directly manage the enterprise. Management rights are delegated to the chief executive and are monitored by company's Board of Directors, unless otherwise stipulated. In addition, insulation from political interference can be reinforced by empowering SOE Boards. Whereas the government, as the shareholder of SOEs, has a legitimate right to influence SOEs, the scope and extent of influence in practice has been excessive and calls for some limitations. Namely, appropriate roles for the government includes setting objectives and performance targets, appointing directors, monitoring the performance of the enterprise and its Board. Aside from these intervention rights - which need to be clearly spelled out and publicly disclosed - the remaining authority should sit with a professional Board and management.

The implementation challenges are nevertheless huge (see Gómez-Ibáñez, 2007 and Vagliasindi, 2008a). For developing markets where the rule of law is not widely respected the benefits of a legal separation of SOEs from government and greater transparency may not materialize. Similarly, building competent and well-functioning SOE Boards is more difficult, not least because there are fewer qualified individuals available to serve as directors. Too often, SOE Boards are populated with people chosen for their political allegiance rather than business acumen. In many countries, for example, the Boards of many SOEs are still filled with senior government or military officials who do not possess relevant skills and experience. Statutes often called for Ministers to hold seats on Boards (see Box 1). Many such appointees are not active members of the Board.

#### **Box 1**

##### **The Cases of Bosnia and Herzegovina (BiH) and Zambia**

In BiH, corporatisation was slow process, partly as a result of the challenge of producing inventories of assets and liabilities for the successor utilities. The utilities were initially chartered under special sectoral legislation, but later transformed into government-owned joint stock companies under company laws. In both entities of BiH, in the case of the power utilities it was the Ministry of Energy which was responsible for representing the government's ownership interest, with the Minister or Assistant of Energy sitting as Chairman of the utilities' Supervisory Boards. In theory, members of Supervisory Boards have employment contracts with the company, and can only be removed with due cause. In practice, all members of Supervisory Boards, at all levels of government, are replaced when a new government takes office. This reinforces the perception that Supervisory Boards fulfill a political or regulatory role, the goals of which are set by the government in office; rather than a professional one, the goal of which is to ensure that the utility is operated as a going concern. The utilities' Boards of Directors in other countries of Africa (such as Zambia) do not exert the most important influence on the company, even in the presence of independent directors. The crucial oversight relationships are not between the utility and its formal government and regulatory overseers - but between the chief executive of the utility and the office of the President.

*Source:* Martin and Cox (2004) and Vagliasindi (2008b)

As a result, many SOE Boards tended to be dominated by middle-level civil servants, few with relevant technical or commercial experience. Typically, the same civil servants would sit on many Boards, diluting their capacity to monitor corporate events. The implicit role of Board members became to protect the interest of their ministry, a task often at odds with bringing efficiency improvements. Boards were seldom provided with any role in the selection of management. Even where targets of performance were set, inadequate explanations for shortfalls in performance were not questioned. Many politicians and public officials in developing countries have used SOEs to provide gifts (transport, housing), Board membership, jobs for themselves relatives and supporters, and in some cases even procurement kick-backs.

On the basis of these factors, whereas Board composition and independence are certainly a very important ingredients of corporate governance reforms, procedural rules also have a role to ensure that directors are empowered so as to make a contribution to the Board functioning. Additional requirements may need to be put in place to avoid having “passive” directors. A particular problem that seems to be emerging in developing countries is the excessive turnaround of directors which does not allow them to exercise any influence in corporate events (see Box 2).

#### **Box 2**

##### **The Case of West Bengal Power Sector Restructuring**

The experience in the power sector of a number of Indian states shows that many times directors are removed before completion of their terms without any form of explanation. To prevent such occurrences, in West Bengal a process of removing directors was also incorporated as part of the Article of Association of the newly established unbundled entities. The minimum tenure for directors was specified as 3 years to provide stability and certainty.

The provisions on number of directors established the composition of Board of directors as described below: i) at least 50% of the directors non-executive Directors; ii) at least one-third of the directors will be independent directors; iii) subject to the above, the Government may nominate the remaining directors on the Board of the company being either executive or non-executive directors. A selection process was also outlined for selection of both functional and independent directors in the Article of Association.

*Source: Khanna and Vagliasindi (2007)*

### **3. Composition of the Board and Independence**

Policymakers in several countries have turned to independent directors as an important element of legal and policy reforms in the field of corporate governance both in developed and developing countries. This has translated into many codes and best practice recommendations requiring the introduction of a minimum percentage of independent directors both for the Board as a whole as well as for some sub-committees, with particular reference to the audit committees.

Britain’s own set of corporate scandals led to one of the most influential reports, the Cadbury Report, which recommended, along with subsequent similar reports and studies, a greater role for outside and independent directors. The last decade has seen a number of corporate law reforms in Japan designed to enhance the role of directors and auditors not tied to management. In the United States, insider-dominated Boards have been rare for years. Although the New York Stock Exchange

(NYSE) has required that independent directors constitute a Board majority in domestic companies only since 2004, as of 2001 approximately 75% of NYSE-listed companies already had such majorities. The modest role for independent directors contemplated in the listing rules of the NYSE a few years ago has given way, in the wake of Enron and other corporate scandals, to federal mandates for listed companies under the Sarbanes-Oxley Act (SOA). Under the current NYSE listing rules, the Board overall must have a majority of independent directors.

The experience of some emerging countries can be particularly enlightening. The interest of China in independent directors pre-dated the corporate scandals that led to federal-level corporate governance reforms in the United States, possibly because of the many similar scandals that had already occurred among companies listed on the two Chinese stock exchanges. Chinese policymakers and academics despaired of the power of the Supervisory Board to act effectively, and began promoting the institution of independent directors, particularly in publicly listed companies, as a way of strengthening supervision. In August of 2001, the China Securities Regulatory Commission (CSRC) issued its Guidance Opinion on the Establishment of an Independent Director System in Listed Companies. Covering all companies listed on Chinese stock exchanges it constituted the most comprehensive measure taken to that date, or since, by the CSRC to regulate internal corporate governance through the institution of the independent director. It was also borrowed from the United States corporate governance law and practice, and as such reveals the drawbacks relevant to legal transplants of corporate governance rules (see Box 3).

### Box 3

#### Legal Transplants of Corporate Governance - The Case of China

The Independent Director Opinion in China seems to give special powers to independent directors by requiring that they constitute at least half of the members of a Board's audit, nomination, and compensation committees. On the other hand, there is no requirement that these committees be established, so a company could keep inside director control over such matters by having them decided by the entire board. In addition, independent directors have been endowed by several powers, including: i) to approve important transactions with affiliates; ii) to recommend engagement or dismissal of the company's accounting firm; iii) to recommend the holding of interim shareholders' meetings; and iv) to hire outside auditors and consultants (at the company's expense). Some of these powers are, however, ambiguous. For example, independent directors apparently do not have the power to actually call a meeting of shareholders or the Board; they have only the power to recommend to the Board that such a meeting be called. More importantly, the Opinion does not actually confer these powers on independent directors. It calls on companies to confer these powers, presumably through provisions in their articles of incorporation or other internal rules.

*Source: Clarke (2006)*

In response to the 1997-1998 East Asian financial crisis, Korea adopted corporate governance rules in 1999, requiring "large" firms (assets > 2 trillion won, around US\$2 billion) to have 50% outside directors. Smaller firms must have 25% outside directors. India's also adopted major governance reforms in 1999, such as Clause 49 which requires, among other things, audit committees, a minimum number of independent directors, and CEO/CFO certification of financial statements and internal controls.

### *How to ensure director independence?*

The mechanisms through which director independence can be ensured fall at least into four large categories (see Box 4 for the definition of independence). The first one is to tighten the standards and rules of disqualifying relationships, including current employment by the firm and dimensions of potential connectedness. Throughout the 80s and 90s, panels and “blue ribbon” committees developed influential “best practice” guidelines for relationship tests. The American Law Institute (ALI)’s 1992 Principles of Corporate Governance recommended that the Board of a public corporation “should have a majority of directors who are free of any significant relationship with the corporation’s senior executives.” “Significant relationship” was defined in a way to disqualify many affiliated directors, both through categorical exclusions relating to the firm’s principal outside law firm or investment bank, and through attention to customer/supplier relationships crossing a relatively low (U\$200,000) economic materiality threshold. The NYSE 2005 corporate governance standards: “no material relationship with the listed company ... including as a partner, shareholder or officer of an organization that has a relationship with the company”.

#### **Box 4 Definition of Independence**

In some countries such as New Zealand, independence means only non-executive. In a number of countries, independence is meant both from the management and from business relationships. This is the case in Australia and in Norway, where private sector experts are not supposed to have any business relation or be in competing business. “Independence” in US state corporate law means only disinterest in a particular conflict of interest transaction. State corporate law attempts to deal with such transactions generally through disclosure to and approval by directors who are not involved in the transaction. It does not require the institution of abstractly independent directors. Instead, it takes a transaction-by-transaction approach. While the concept of the disinterested director is constantly being tested and refined through litigation, there is virtually no jurisprudence on who counts as an independent director for the purposes of the federal laws and regulations calling for them. Disinterested directors are a concept in Delaware’s corporate law, and Delaware has courts and a responsive legislature that sees problems and responds to them. The NYSE rules and SOA, by contrast, carry with them no system for resolving disputes through a fair process resulting in written decisions. The exchanges have only the blunt tool of delisting for the enforcement of their rules. Finally, some countries such as Australia have a broader approach to the independence of Boards. They take into consideration not only the independence of Board members, but also the separation of the Board Chairman from the CEO. It is then the role of the Board to select the CEO, although responsible Ministers are consulted as part of this process. According to the principles in the 2005 EC Recommendation a director is considered independent when free from any business, family or other relationship - with the company, its controlling shareholder or the management - which might jeopardize his or her judgment. The (supervisory) Board should be composed of members who, taken together, have the diversity of knowledge, judgment and experience to properly complete their tasks. All directors should devote to their duties the necessary time and attention. When the appointment of a director is proposed, his or her other significant professional commitments should be disclosed.

*Source:* Clarke (2006) and EC (2005)

A second mechanism for independence is to increase penalties and incentives, such as legal liability for fiduciary duty breach, reputational sanctions, and stock-based compensation. The most powerful stick has been in practice the risk of monetary liability for breach of the state law duty of care, which fosters director independence by requiring director attention to the business and affairs of



the corporation, a precondition to the exercise of independent judgment. Directors also potentially face liability under the federal securities laws for material misstatements or omissions in a corporation's financial disclosures.

Reputation provides another stick or carrot to enhance director independence. Presumably directors would not want to be associated with a poorly performing firm or a firm that is stigmatized because of a business scandal, and, instead would want to be associated with a bellwether firm. But the effectiveness of reputation-based incentives is limited by the noisiness of reputation markets: a director suffers a reputational sanction if there is a major financial or legal problem at the firm. In the more typical case of firm underperformance or a minor legal problem, however, there may be little or no reputational effect. Finally, stock options can be used to strengthen the alignment of director and shareholder interests. This alignment presumably will strengthen director independence, since stockholding directors have stronger incentives to evaluate managerial decisions and tenure in terms of the expected stock price effect rather than their loyalty to the management team. The drawback of these mechanisms is that also particularly in emerging markets few directors would be able to acquire enough stock to achieve a strong incentive effect (assuming that incentives are increasing in ownership levels). Thus directors typically acquired an equity stake through annual stock-based compensation. Accumulating stock in this way can undermine director independence if the CEO has influence over director retention and thus the possibility for further accumulation.

A third mechanism to enhance the independence of the members of the Board of Directors is the development of intra-Board structures, such as task-specific committees and designation of a "lead director". Task specific committees include the audit committee, the compensation committee, and the nominating committee, with a majority of independent directors. Each committee is functionally-tasked in areas where the interests of managers and the shareholders may conflict. This may enhance independence in two ways: 1) the ownership and accountability for a specific critical task may lead to greater autonomy from the CEO in performing that task, 2) the practice of acting jointly and autonomously in a targeted area may carry over to other important roles of the Board, such as evaluating managerial performance and strategy. The establishment of a "lead director" - an independent director who convenes the Board where the chair is a senior executive, typically the CEO - represents a compromise between those who, following the UK model, wanted to separate the roles of chair and CEO and those who felt that such separation would undermine the CEO's authority. Lead directors came to play an increasingly important role in US corporate governance practice, providing an organizational focal point for crises where the CEO's actions have been challenged. Independence of audit committees is another important common listing requirement across developed and developing countries. Companies listed on the New York Stock Exchange must, under the SOA, have audit committees composed entirely of independent directors. Korean listing requirements include an audit committee with an outside chair and at least 2/3 outside members, and an outside director nominating committee. Brazilian corporate law is silent on audit committees, but expressly requires the creation of a separate body, known as a Fiscal Board, charged with examining the company's financial statements and offering an opinion on them (see Box 5).

**Box 5**  
**The Case of Brazilian Fiscal Boards**

Audit committees are uncommon even in most Brazilian listed private firms, but many firms use an alternate approach to ensuring financial statement accuracy -- establishing a Fiscal Board. The fiscal Board can engage experts (presumably a second accounting firm), at the company's expense. About 40% of firms have such a Board but only more than half of the firms include a member with accounting expertise. One might think that the audit committee and the fiscal Board are likely to be substitutes, so that even firms which had one or the other might not have both. This is only partly true. Two thirds of the firms have a Fiscal Board. Of the remaining firms, two have an audit committee, leaving the other with neither an audit committee nor a permanent Fiscal Board. Thus, the Fiscal Board is an important institution in Brazil. Further research is needed to understand its strengths and weaknesses, compared to an audit committee, and whether it makes sense for a firm to have both a Fiscal Board and an audit committee.

*Source: Black et al. (2008)*

What about other sub-committees? The CEO's influence in director selection and retention can be reduced, for example, by the creation of a nominating committee staffed solely by independent directors. Directors picked by the CEOs are likely to feel a strong sense of loyalty to the CEO. In the US, CEOs successfully resisted reforms that would have increased shareholder influence in director selection, including the SEC's 2003 shareholder ballot access proposal. Reforms entailed the creation of a nominating committee with responsibility for vetting and selecting director candidates and to set forth the standards that guide its work so as to provide a basis for ex post scrutiny.

#### **4. Board Procedures**

##### **4.1 Selection and Evaluation Process for Board of Directors**

Political influence in the nomination process is still strong in developing countries. The key challenge is to prevent the process to degenerate into a situation characterized as "political interference". The political interference goes either through the nomination process itself, involving a complex political negotiation among different government organs, or through direct nomination of political appointees. This is often identified as a main weakness of SOE corporate governance, as too often Boards are populated with people chosen for their political allegiance rather than business acumen.

The main way of restricting such governmental or political interference in the nomination of SOE Boards and increasing their independence and professionalism is to put in place a structured nomination process, making sure that the ultimate selection criterion is competency. Moreover, focusing on setting up structured nomination processes allows ownership entities to perform their nomination mission with a limited administrative capacity. Until very recently, not even developed countries established procedures or criteria for appointment of Supervisory Board members, except for the recommendations of the responsible minister presented to the government as a whole. Very few countries, such as Australia, New Zealand and Sweden, have set up such structured and clearly skill-based nomination systems (see Box 6).

### Box 6

#### The Cases of New Zealand and Sweden

In New Zealand, the underlying rationale for the division of responsibilities between the Ministry of Finance on one hand, and the sector Ministries and the Advising Unit on the other hand (CCMAU, Crown Company Management Advisory Unit), is clearly articulated. The Ministry of Finance focuses on both economic efficiency and the fiscal impact of SOEs' performance. Sector Ministries (through the Advising Unit CCMAU) adopt a commercially oriented perspective with a primary emphasis on ensuring that SOEs are successful companies. Therefore, through the CCMAU, sector Ministries take the lead in monitoring performance and have sole responsibility for Board composition. The Crown Company Monitoring Advisory Unit screens potential directors using clearly defined criteria, ensuring that the candidate's skills match the needs of a specific SOE Board. Once an appointment has been made, the appointing ministers must certify in writing that the candidate is the best available and that there are no "unmanageable conflicts of interest." The New Zealand model is based on a systematic evaluation of existing Boards. In view of the corporate strategy and the existing mix of competences and skills, competence and experience requirements are specified for new Board positions. Finally, candidates are systematically identified, interviewed and assessed based on profiles drawn up for each Board position.

In the case of Sweden, uniform and common principles are applied in SOEs for a structured nomination process. The Board nomination process is coordinated by the Division for State Enterprises at the Ministry of Enterprise, Energy and Communications. A working group analyses the required competence on the basis of the company's activities and situation and the composition of the respective Board. Recruitment requirements are then established and recruitment work initiated. Board members are selected from a broad basis for recruitment. When the process has been completed, nominations are to be published in accordance with the guidelines in the Code. This uniform and structured method of work ensures the quality of the nomination process as a whole. In order to be considered for a seat on the Board, a high level of general competence is required either within current business activities, business development, sector knowledge, financial issues or other relevant areas. In addition, a high level of integrity and the ability to see the best interests of the company are required. Every Board member should be able to make independent assessments of the company's activities.

*Source:* OECD (2005) and Corporate Governance Guidelines for New Zealand and Sweden

A few countries have also introduced nomination committees, but only for listed SOEs. These committees may exist at the company level or for all SOEs, and are to a certain extent based on the model of the UK's Commissioner for Public Appointments. The government requires that the process be efficient, transparent and based on merit, excluding political activity and affiliation from selection criteria. Moreover, all stages are subject to audits. Such models have to some extent being also adopted by developing countries. South Africa's King Report on Corporate Governance (2002), which is applied to listed companies but also to SOEs, requires formal and transparent procedures for appointment of directors to the Board, assisted by the nomination committees. Legal transplants of corporate governance rules have not always been successful, though. For instance, the Chinese CSRC requires companies to submit a list of proposed independent director nominees and their qualifications. The CSRC is then to vet the nominees and indicate approval or disapproval within fifteen days. Candidates disapproved by the CSRC may not be independent directors, but may still be directors. The company's Board of Directors must report the CSRC's disapproval to shareholders at the meeting where the directors are to be elected. The CSRC can probably handle the workload in terms of processing paper. Local offices, which will handle the approval process and have fifteen days to vet nominees, have over 1200 staff members who could perform reviews, or about one per listed

company, on average. The real issue lies in whether, given the many and subtle ties that may exist between nominees and company management, independence can really be ascertained in the abstract on the basis of paper submissions by management, and whether independence so ascertained is really meaningful.

With or without a structured nomination process, a growing number of countries maintain databases of qualified candidates. They also increasingly rely on the professional services of recruitment agencies to fulfill this key task of Board nomination, such as Finland or Sweden. The development of such practices would help in enlarging the pool of potential experts for SOE Boards, especially to bring in more private sector experience, thereby improving SOE Boards' professionalism. In Poland, the Ministry of State Treasury requires potential candidates to SOE Supervisory Boards to pass an exam before receiving a special certificate and being registered in a database. The database for SOE directors includes 35,000 names for 5,000 positions as of 2005. The fields of expertise for candidates wanting to be Treasury representatives on SOEs' Supervisory Boards include legal knowledge (related to the Civil Code, Commercial Company Code, Labor Code, Bankruptcy Law and court conciliation procedures, commercialization and privatization procedures) but also corporate governance (including the role of Boards, GSMs) and business (management, marketing, business plans, accounting, corporate finance, valuation methods, restructuring, state aid for enterprises).

#### **4.2 Training and Evaluation of Boards of Directors**

Apart from managing appointments to Boards, the ownership entities are also increasingly involved in setting up induction processes. In the case of SOEs, these induction programs often include training in Board responsibilities, the SOE's relationship with the government and Ministries concerned, and Board procedures. Such induction training enhances Board professionalism. Ownership entities are also increasingly active in monitoring on an on-going basis Boards' and directors' performance to ensure a smooth evolution of Board structure and composition.

Public trust in Boards of Directors depends on transparent governance structures and processes and clear accountability to stakeholders. The assessment of Board performance is essential for demonstrating accountability and generating public trust. One can choose to evaluate individual Board members, in order to help give participants the opportunity to improve their own effectiveness and better put their talents to use. One can also evaluate the Board as a whole – something the Nominating or Governance Committee may do as part of their mandate.

There are three areas where the searchlight of review might be directed: participation, process, and performance. Participation examines the involvement of the individual Board member. By law, Board members have fiduciary responsibilities – the duty of care, the duty of loyalty, and various other duties – that they are expected to discharge. Process and system evaluations are concerned with how the Board and its committees operate, the role played by the chair, and the support provided to the Board by staff. In this context, the role of the Board chair, or executive committee, in formulating the Board's agenda must be looked at as well as the Board's focus on issues related to its governance responsibilities (or conversely, its time consumed with side issues or staff briefings "for information").

Issues of whether the Board receives the information it requires to monitor performance at a strategic level, and whether this information is presented in a form that can be easily understood, so as to provide a good basis for decision-making, must also be considered. System evaluation relate also to the organization's governance system. For example it includes issues such as whether committees, task forces have clear terms of reference and how they report to the Board. The Board should also have governance policies for topics such as conflict of interest, the role of the chair or external communication and adherence to relevant bylaws. Finally, performance is concerned with the results or outcomes of Board activity. This is where judgment is particularly required, as the issues are complex. The evaluation in this case would require to assess whether the Board contribute effectively to the formulation of the organization's vision and strategy and perform its risk management role and financial oversight, including the capacity to handle an unexpected crisis if one arises.

What about other procedural rules? When comparing listing requirements and corporate governance codes for developing countries to those adopted by developed economies, it is striking to see that the number of additional requirements in the former group. For instance, the Indian and South African listing requirements both prescribe that the Board of Directors as a whole and the Audit Committee should meet at least four times a year. Whereas the Indian listing requirement also impose limitation on the number of Boards where a director can sit (equal to 10) the South Africa Code of Corporate Governance Practices and Conduct (coming from the King Report, 2002) advise non-executive directors to “carefully consider the number of appointments they take in that capacity so as to ensure that the companies on which they serve enjoy the full benefit of their expertise, experience and knowledge”.

## **5. Insights and Prediction from the Theoretical Models on Board of Directors**

### **5.1 Principal Agent Approach**

The existence of a Board of Directors can be explained as the (possibly second best) equilibrium solution to agency problems confronting the firm with such a potentially large divergence in interests among its members. The canonical agency problem exists between a firm's owners, namely, its shareholders, who are generally not able to control management directly, and management. This problem, as well as the underlying direct control problem, could be mitigated by the presence of a large outside shareholder, as the seminal contribution by Shleifer and Vishny (1986) shows. However, this holds only under particular circumstances and is unlikely to provide a universal solution. Moreover, the stage on which a large shareholder plays this role is often the Board itself.

Although such principal-agent modeling provides many insights, it is not particularly useful for explaining Board-specific phenomena: for example, why the ratio of insiders to outsiders matters, or why management seems to have such influence on the selection of directors. Outside directors are often thought to be better able to exercise a more effective monitoring role of management. Yet the incentives are not clear. Earlier economic literature, starting from the contribution of Fama (1980) and Fama and Jensen (1983) emphasize their incentives to build reputations as expert monitors. However, such arguments are not fully convincing, as such incentives can be outweighed by incentives to build

a reputation as a director who is “friendly’ to senior management. Smith (1776) is one of the first economist to identify the lack of incentives for directors: “The directors of [joint stock] companies, however, being the managers rather of other people’s money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance [as owners] . . . . Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.” (p. 700). One hundred and fifty-six years later, Berle and Means (1932) took a largely similar view. Moreover, as Holmstrom (1999) observes, wanting to be *seen* as doing the right thing and *doing* the right thing are not always the same. The incentives facing outside directors that result from these divergent forces are an important underlying factor in many of the studies surveyed below.

## 5.2 Board Specific Models

Hermalin and Weisbach (1998) offer a more Board-specific model. They focus on one of the primary Board tasks: the hiring and firing of management. In their model, the Board must decide whether to keep senior management (the CEO) or to replace him. The firm’s performance provides a signal of the CEO’s ability, and the Board may, if it chooses, obtain an additional, costly signal. The Board’s inclination to obtain this signal is, in turn, a function of its independence from the CEO. A Board’s independence depends on a bargaining game between the Board and the CEO: the CEO prefers a less independent Board, while the Board prefers to maintain its independence. When the CEO has bargaining power, the Board’s independence declines. One of the key problems facing Boards is quite intuitive, coming from the conflict of interest between the CEO and the directors. The CEO has incentives to “capture” the Board, so as to ensure that he can keep his job and increase all benefits connected with his managerial position. Directors have incentives to maintain their independence, to monitor the CEO, and to replace the CEO if his performance is poor.

Adams and Ferreira (2007) also analyze the consequences of the Board’s dual role as advisor as well as monitor of management. Given this dual role, the CEO faces a trade-off in disclosing information to the Board. If he reveals his information, he receives better advice; however, an informed Board will also monitor him more intensively. Because of this, the CEO may be reluctant to share information with it. Thus, management-friendly Boards can be optimal.

In a single Board model, moral hazard problems arise because the CEO’s preferred projects differ from those of the shareholders. When monitoring by the Board is successful, the Board effectively controls project selection, and the CEO, unable to implement his preferred projects, loses valuable control benefits. When the Board does not control project selection, the Board advises the CEO. The crucial assumption is that the quality of the Board’s advice improves as the CEO provides it with better information about the firm’s investment opportunities. Accordingly, the CEO faces a trade-off in sharing information with the directors, as the more precise the Board’s information about these options, the greater the risk to the CEO that the Board will interfere in decision making.

When the two advising and monitoring roles are separated, the CEO does not face a trade-off in providing information. The Adams and Ferreira (2007)’s model shows that under certain conditions, shareholders prefer a dual Board system to a sole Board system. While the dual Board

structure allows for the separation of the Board's two roles, it is possible to replicate this structure by separating the roles through the use of Board committees. For example, one can view the audit committee in the sole Board systems of the United States and the United Kingdom as fulfilling some of the functions of a supervisory Board. Under this interpretation, this model may also shed some light on the policy debate concerning audit committees. Policies that enhance Board independence may be detrimental for shareholders in a sole Board system, but not for shareholders in a dual Board system. Second, while the sole Board structure can achieve the first-best outcome for shareholders more often than the dual Board structure can, the latter is sometimes the second-best option for shareholders.

### 5.3 SOE Specific Problems

What about the modeling of specific SOE challenges? Here we summarize the key issues (for a detailed review, we refer the reader to Vagliasindi, 2007). Multiple principals dominate the public sector. SOE strategic goals are difficult to be clearly defined, due to the presence of multiple and sometimes conflicting objectives and multi-principals; namely, different control organs within the public sector with different priorities and different perceptions of what the strategic goals should be. As a consequence, SOE management finds itself accountable to and monitored by a shifting coalition of interest groups, consisting of politicians, bureaucrats, labor unions, and a plethora of different other stakeholders. Politicians and bureaucrats, however, are typically poor overseers of SOEs. Like ordinary people, they are self-interested individuals who seek to attain, exploit, and maintain power. So, for instance, a politician may take steps to forestall the closure of an unprofitable SOE located in his electoral district in order to boost his re-election prospects. Politicians and bureaucrats are also poor agents because they do not benefit – financially and otherwise – if an SOE is highly profitable but may be blamed when an SOE acts “too commercially” (for example, undertaking layoffs) or other things go wrong. Typically, they are called to account when things go wrong but not commended when things go right. As a result, they are much more risk-averse than private shareholders – ministers and their civil servant subordinates, rationally, seek to avoid anything controversial within their portfolios for which they could be blamed.

Multiple goals also create challenges. The basic efficiency goals include providing services that consumers value and producing those services efficiently and at an affordable price. It is worth noting that productive and allocative efficiency cannot be reached by relying on unregulated market forces, apart from very specific market structures (e.g. perfect competition) which are rarely found in the context of infrastructure service provision. In the absence of regulation, a private monopoly would restrict output (leading to too high prices) and provide a level of quality that is too low. On the other hand, guaranteeing allocative efficiency (in the theoretical case, reaching marginal cost pricing) can require a substantial amount of public funds. In the presence of economies of scale, this may increase the budget deficit and constitute a challenge in term of fiscal policies and macroeconomic stability in developing countries. Equity goals include ensuring universal access to services, if necessary, by charging tariffs below costs or extending service into unprofitable areas. SOEs are given additional developmental objectives, such as ensuring employment, creating necessary infrastructure for economic development, and so forth. Redistributive aims are often present, especially with the aim of

protecting the poor. Many economists would argue against the use of pricing to redistribute income and would consider progressive income taxation and welfare subsidies to be more effective means to redistribute income. Redistributive price distortions can, to some extent, damage the efficiency of the overall economic system.

Multiple objectives arise either because they are mandated by legislation or because a number of government ministries are in a position to exert influence on SOEs. The latter situation becomes especially problematic if the ministries have different aims for SOE and do not reconcile their divergent views (see Vagliasindi, 2008a). For instance, when shares are held jointly by the treasury and line ministry, the treasury may be concerned principally with the impact of the SOEs on the government's budget, while the line ministry may focus on increasing the quality of the service with less regard to costs. This can give rise to major conflicts between the SOEs and the government, as the case of Kosovo illustrates (see Box 7).

**Box 7**  
**The Case of Kosovo**

In Kosovo, the central importance of the infrastructure sectors – and particularly of the two largest SOEs, the electricity and telecom service providers, respectively KEK and PTK – to the health of the wider economy is widely acknowledged. The combined turnover of KEK and PTK in 2004, at approximately €240 million, was equivalent to about 10% of GDP, and 40% of KCB revenues; and the SOEs are major employers. The services provided by the SOEs are essential to broader economic development, so that ensuring their efficient operation has a macroeconomic, rather than a purely sectoral, impact. The performance of KEK in particular is also very important for political stability – electricity supply being a basic necessity. An asymmetry of treatment emerges strongly. Whereas KEK's financial losses are absorbed by the KCB, no part of PTK's profits were. PTK was only allowed to declare dividends for 2005 and 2006. Moreover, PTK will also provide a loan to KEK under a special trust fund administered by the Treasury.

The current institutional framework of the public enterprise sector generates a complicated set of incentives which are generally not conducive to the efficient operation of the SOEs. On the one hand the Provisional Institutions of Self Government (PISG), which are responsible for fiscal outcomes, have little control over the SOEs. The fact that the both Boards and senior management of the SOEs have been delegated to foreign contractors and the Board also composed by independent foreign directors has only increased the conflictual relationship between the SOEs and the PISG which practically precludes the type of co-operation required to resolve the problem of the substantial fiscal burden represented by the public enterprise sector.

*Source: Vagliasindi (2008b)*

What can be done to reduce such problems? First of all, governments may want to set clear objectives for SOEs. If improved financial performance is the goal, then state overseers must set specific targets. The performance measure doesn't necessarily have to match what might be achievable in the private sector – where profit maximization tends to be the only objective. Nonetheless, performance targets must ensure that an SOE will – when the costs of non-commercial objectives are stripped out – recover its cost of capital. In Sweden, the government and an SOE's Board agree annually on detailed financial targets, based on the performance of internationally successful competitors.



Only when the government is confident that a SOE is viable from a financial perspective the company could be asked to pursue non-commercial objectives, such as employment stability, cultural preservation, and so forth. Any other approach risks the company's long-term viability. In cases where the government sets multiple objectives, they could be ranked by priority, with clear guidelines about how to make trade-offs among secondary objectives. Few governments have done this so far. In addition, governments could calculate the cost to the company of pursuing noncommercial objectives and disclose it publicly. Better yet, separate funding could be provided to pay for non-commercial objectives.

Information could be provided not only on performance but on the objectives of each enterprise (especially non-commercial ones), the costs of pursuing non-commercial objectives and subsidies granted by the government. Equipped with this information, increased scrutiny by the public, press and non-governmental organizations raises accountability, both for SOE management and government overseers. In Sweden, SOEs are required to issue detailed quarterly reports, including financial statements and a management discussion on operations and risks. Many of these best practices have been adopted by South Africa (Box 8).

**Box 8**  
**The Case of South Africa**

According to the SOE policy of South Africa, as a matter of principle, an SOE will not receive National Budget support for its operations or capital expenditure unless the state exercises its right to increase the capital of the SOE or to support specific capital programs. All National Treasury guarantees are provided at cost to the entity and should as a practice be discouraged, unless government takes a specific decision based on the commercial or financial circumstances of the SOE. The SOEs are established under the Companies Act and are expected to comply with all legislation that would affect a private entity. In the case of Sector Charters, SOEs are expected to comply with all the provisions, with the exception of the shareholding provision to the extent of the equity owned by the state.

Among the corporate governance milestones, the Department of Public Enterprises aims at:

- strengthening the composition, performance and evaluation of the Boards of Directors of SOE through: i) Skills demand profiling, improved vetting of directors and a shadow Board database; ii) Board induction programs; iii) Annual Board evaluation; and iv) Remuneration guidelines;
- strengthening of the shareholder - Board relationship through: i) continuation of the Chairs and CEO fora; ii) more regular strategy focused (general) meetings between the shareholder and Board to facilitate deliberation on the strategic intent; iii) improving information related to and consideration of transactions subject to shareholder approval through the revision of transaction management guidelines including a materiality and significance framework; and iv) formulation of a SOE-wide dividend policy (in consultation with National Treasury).

*Source: South Africa's Department of Public Enterprise Annual Reports*

In developing countries, SOE managers are seldom given the resources and incentives and above all the autonomy to lead; they are rarely punished for poor practice and even less often rewarded for good. In many instances, SOE managers possess autonomy in areas where they should have been closely monitored (such as financial reporting) and they generally lacked decision-making

power concerning day-to-day operational matters, as the case of Pakistan powerfully shows (see Box 9).

**Box 9**  
**The Case of Pakistan**

Though WAPDA was largely unbundled in 1998, the successor companies have not been given, so far financial autonomy and WAPDA has continued to tightly manage the affairs of the sector. While perhaps useful during a transition period, until the companies and the government build capacity, this arrangement substantially constrains the autonomy of the decision making powers of the companies and contains significant conflict of interest. Boards of Directors are not fully empowered to effectively govern the companies within the mandate under the Company Ordinance and Memorandum and Articles of Associations of the companies. The delegation of powers for these companies usually requires any item of material significance to be referred to WAPDA.

Moreover, WAPDA is still considered as the focal point for technical advice, endorsement of decisions and the final approval authority. For instance, chairman PEPCO - who has until recently been also Chairman WAPDA - exercised the ownership function, including the appointments of all the Board of Directors, including the representative of the private sector. The integration of chairmanship of PEPCO and WAPDA contributed to further constrain the autonomy of the decision making powers of the companies and contains significant conflict of interest. Generally, 3 out the 7 directors are from the private sectors, with the exception of IESCO, that has 4 non-executive directors. Although their presence in the Board has been a welcome improvement, full value has not been realized due to the limitations described above.

WAPDA has until recently also exercised full control on all staff on and above grade 18 for all WAPDA-successor entities, both in terms of selection and promotion. Many companies face challenges in exercising autonomous decisions in HR. Some of them face difficulties in increasing the salary to attract and/or keep suitable candidates for crucial staff, including Chief Financial Officers. Moreover, promotion is mostly based on seniority, rather than merit. Performance-based pay for the staff has not been introduced and there are little incentives to improve performance.

*Source: World Bank Pakistan: Transmission and Distribution Power Project, Aide de Memoire, 2007*

More attention should also be paid at the interface between regulatory rules and internal incentives: "sticks" (penalties) for SOEs are problematic and "carrots" may not translate into incentives within the organization, given civil service salary constraints. More credible penalties should be considered beyond the traditional ones under external regulatory schemes. How can the regulator influence internal reward systems for SOEs? These dilemmas have not yet been adequately addressed. However, even in the absence of a sectoral regulator, the Ministry of Economy and/or Finance -- as the steward for citizen/taxpayer investments -- could be instrumental in devising contractual arrangements, governance/accountability procedures, and incentive programs (with "hard" targets") that promoted strong performance (see Box 10).

**Box 10**  
**The Case of NWSC**

In an effort to address managerial inefficiencies in the Uganda state owned service provider, NWSC, the government appointed a new Board of Directors. The new Board included representatives from local governments, business community, professional bodies, environment, ministry of finance, ministry of water, ministry of health, and small- scale industries. The composition and structure of the Board enabled it to exercise its governance functions properly, and it was able to shield the corporation from political interference and patronage. The new Board, in turn, appointed a new managing director, who was given the mandate to re-think strategies for performance improvement. The appointment led to an emphasis on commercial viability, utilizing “customer care” as an organizing theme. The new Board and management came up with a series of programs to ensure enhanced performance, including:

- 100-Days Program (Feb-May, 1999) was a high-impact program that focused on reversing operational and financial inefficiencies through aggressive revenue collection strategies and cost-cutting measures. A number of cost-cutting measures implemented during this program include rationalization of the medical scheme and reduction of travel costs.
- Service and Revenue Enhancement Program (August, 1999-August, 2000) aimed at restoring customer confidence in the ability of NWSC to deliver services. Under this program, NWSC established customer service centers and front desks, conducted customer surveys to capture customer wants, and instituted amnesty for illegal water use.
- Area and Service Performance Contracts (2000-2003) focused on making service providers reach commercial sustainability: managers had the authority to make important decisions and were accountable for outcomes.

*Source: Mugisha and Berg (2006)*

## 5.4 Theoretical Predictions

The Hermalin-Weisbach and the Adam-Ferreira models derive a number of predictions about the dynamics of the CEO-Board’s relationship:

1. CEO turnover is more sensitive to performance when the Board is more independent.
2. The probability of independent directors being added to the Board rises following poor firm performance.
3. Board independence declines over the course of a CEO’s tenure.
4. Accounting measures of performance are better predictors of management turnover than stock price performance.
5. A CEO’s salary should be insensitive to past performance at relatively low levels of past performance, but sensitive at relatively high levels of past performance.
6. Boards are more effective ways of supplying information to management in a dual model rather than in a sole Board
7. The presence of the audit committee composed by independent directors can help solving moral hazard issues on the provision of insider information by management.

There is strong empirical evidence to support the first five of these predictions. For instance, Weisbach's (1988) results are consistent with the first prediction; Bhagat and Black (2000) and Hermalin and Weisbach (1988) find results that are consistent with the second and third predictions; and, likewise, the fourth prediction is supported by numerous studies, of which Weisbach (1988) is just one example. For the other predictions there is still little evidence.

There are other stylized facts about Boards that do not, as of yet, arise as equilibria from formal models. Would the best Board combine both independent directors (unconflicted, but also uninformed) and insiders (who are conflicted but best informed)? Would the length of service (not too short), age (not too old) and capacity (given by a proxy such as the number of Boards in which director sit) matter? Does the separation between the CEO and the chairman of the Board (which is often a requirement) make a difference? Why does Board *size* appear to affect performance?

## 6. Enterprise Level Empirical Evidence

Most work on the connection between Board structures or other aspects of corporate governance and firm value or performance face a set of empirical challenges, which make identification difficult (see Hermalin and Weisbach, 2003). Several recent articles contend that because of these challenges, we still know very little about the effects of Board structure, or corporate governance more generally, on firm value or performance (Chidambaran, Palia and Zheng, 2006; Lehn, Patro and Zhao, 2006; Listokin, 2007).

Both endogeneity considerations and the equilibrium nature of the results complicate empirical work on Boards of Directors, as well as most other empirical work on governance. First, almost all the variables of interest are *endogenous*. For instance, firm performance is both a result of the actions of previous directors and itself a factor that potentially influences the choice of subsequent directors. A second likely form of endogeneity involves optimal governance varying across firms, based on firm characteristics, so that even if a governance attribute correlates with firm value in cross-section, this does not imply that this attribute would be valuable at other firms (Demsetz and Lehn, 1985). For evidence on the factors that influence Board composition, see, e.g., Boone, Field, Karpoff and Raheja (2007), Gillan, Hartzell and Starks (2006); Agrawal and Knoeber (2001). A third possibility is that firms may use governance to signal good underlying attributes, but governance has no separate effect on value or performance.

In addition, many empirical results on governance can be interpreted as either equilibrium or out-of-equilibrium phenomena, bearing drastically different implications for policy. The out-of-equilibrium interpretation of a negative correlation between Board size and performance would suggest that from a policy perspective limits on Board size should be encouraged. In contrast, the equilibrium interpretation of this result implies that some other factor is causing both Board size and profitability, so that such regulation would be at best useless and possibly counterproductive.

A further problem in many emerging markets is omitted variable bias. Different aspects of governance are often positively correlated. Moreover, a wide range of firm characteristics could plausibly predict both Board structure and firm value or performance. Yet most studies control for a

limited set of governance attributes and other firm characteristics. At a minimum, to solidly establish association (even without identification), one would want to use time series data and a firm fixed effects specification to address whether unobserved time-invariant firm characteristics explain an observed correlation between governance and market value.

## 6.1 Board Composition and Performance

The first method has been to examine contemporaneous correlations between accounting measures of performance and the proportion of outside directors on the Board. The presence of outside directors in the Board and measures of accounting performance appears to be not significantly related, both when standard accounting performance measures are used, as in MacAvoy et al. (1983), Hermalin and Weisbach (1991), Mehran (1995), Klein (1998), and Bhagat and Black (2000) and when Tobin's Q is used as a measure of performance, as in Morck et al. (1988). Even correcting for endogeneity using instrumental variables, both Hermalin and Weisbach (1991) and Bhagat and Black (2000) found no empirical relationship between Board composition and firm performance.

Yermack (1996), Agrawal and Knoeber (1996) and Bhagat and Black (2002) find a negative relationship in the U.S., as do Erickson, Park, Reising, and Shin (2005) in Canada. Bhagat and Black (2002) and Erickson *et al.* (2005) report evidence that the negative relationship reflects reverse causation, in which firms which experience poor performance increase the independence of their Boards. In the U.K., Arcot and Bruno (2006) and MacNeil (2006) report that well-performing firms are more likely to depart from the "comply or explain" recommendation to have at least 3 outside directors. The only study with plausible identification is Dahya & McConnell (2007). They find improved operating performance for U.K. firms which previously had only one or two outside directors, but increase this number to three to comply with the Cadbury Committee "comply or explain". However, identification is imperfect, because firms can still choose to have fewer than three outside directors. Wintoki, Linck & Netter (2007) find a negative relationship between independence and performance using OLS, which flips sign with firm fixed effects and disappears with GMM approach with U.S. data. On the theoretical side, as shown in the section above, there is no reason to expect a monotonic relationship between Board independence and measure of firm performance or value.

In contrast to the mixed findings in developed markets, several studies find a positive cross-sectional relationship between Board independence and firm performance. Positive effects of director independence have been found in several individual countries, including Korea (Black, Jang and Kim, 2006a and Choi, Park and Yoo, 2007, Black and Kim, 2008); Taiwan (Yeh and Woidtke, 2005), and Ukraine (Zheka, 2006) and Black & Khanna (2007, India). As reported in Section 3, in response to the East Asian financial crisis, Korea adopted governance rules including the introduction of 50% outside directors, an audit committee with an outside chair and at least 2/3 outside members, and an outside director nominating committee. Smaller firms were also required to have 25% outside directors. Black & Kim (2008) finds in a firm fixed effects framework: i) similar share price gains for large firms, which are legally required to change Board structure, and smaller firms which do so voluntarily; and ii) evidence for the separate value of Board independence and the introduction of audit committees. Dahya, Dimitrov, and McConnell (2007) report cross-country evidence for a 22-country sample

including both developed and developing countries, with independent directors having a stronger effect in countries with weaker governance. No test has been made to check whether the results will survive just for these countries and even if that was the case the same result may not necessarily hold for other developing countries.

A somewhat more successful approach has been to measure the impact on firm value of changes in Board composition. Rosenstein and Wyatt (1990) examine the stock price reaction on the day of the announcement that outside directors will be added to the Board. Presumably, firms change their Board structure to improve their operations and, thus, ultimately their value. Rosenstein and Wyatt (1990) find no definitive effect of adding an insider to the Board. In some specifications, however, they find that adding an insider increases the stock price. Positive results were found in the case of India (Black and Khanna, 2007), where the May 1999 announcement by Indian securities regulators of plans to adopt what became Clause 49 was accompanied by an increase in the price of large firms. Mid-sized firms had an intermediate reaction. Faster growing firms gained more than other firms, consistent with the notion that firms that need external equity capital benefit from better governance rules. Cross-listed firms gained more than other firms, suggesting that local regulation can sometimes complement, rather than substitute for, the benefits of cross-listing. The positive reaction of large Indian firms contrasts with the mixed reaction to the Sarbanes-Oxley Act (which is similar to Clause 49 in important respects), suggesting that the value of mandatory governance rules may depend on a country's prior institutional environment.

Board composition notwithstanding, Jensen (1993) and Lipton and Lorsch (1992) suggest that large Boards can be less effective than small Boards. The idea is that when Boards become too big, agency problems (such as director free-riding) increase within the Board and the Board becomes more symbolic and less a part of the management process. Yermack (1996) finds support for this hypothesis for a sample of large U.S. corporations. Eisenberg *et al.* (1998) document a similar pattern for a sample of small and midsize Finnish firms. Another measure of the importance of Board size is how participants in the marketplace view it. Gertner and Kaplan (1996) examine the Boards of a sample of reverse-leveraged buyouts, finding that Boards tend to be smaller than in otherwise similar firms. Wu (2000) considers the evolution of Board size over the 1991-95 period, finding that Board size decreased on average over this period and that the decrease can be explained at least partially by pressure from active investors.

## **6.2 Boards of Directors and Board Actions**

In addition to studying the relationship between Board characteristics and firm performance, a number of studies have examined how Boards accomplish some of the responsibilities commonly assigned to directors. This approach has several advantages relative to looking at the effect of Boards on overall firm value. First, this approach is potentially more powerful because it is less prone to unobservable factors contaminating the statistical relationship. Second, it is less likely that the endogeneity of Board composition will affect the results.

The most commonly discussed responsibility of the Board is to choose and monitor the firm's CEO. A large number of papers have documented a positive relationship between CEO turnover and

poor performance. In addition, Denis and Denis (1995) document that firm performance generally improves following a CEO turnover, especially a forced turnover. An important issue in all of these studies is the distinction between voluntary and involuntary turnovers, which is usually difficult to make. To better identify the role played by the Board, Weisbach (1988) interacts Board composition and firm performance in a CEO turnover equation. His results indicate that when Boards are dominated by outside directors, CEO turnover is more sensitive to firm performance than it is in firms with insider-dominated Boards.

This result is consistent with the view that outsider-dominated Boards—those a priori likely to be independent of management—are responding to corporate performance when they make CEO retention decisions. In contrast, turnover in insider-dominated Boards is not performance-driven, suggesting that insider-dominated Boards make turnover decisions for reasons unrelated to corporate performance.

The most plausible interpretation of this finding is that Boards controlled by outside directors do a better job of monitoring the CEO than do Boards controlled by inside directors. Inside directors' careers tend to be tied to the CEO's, which gives them incentives to advance the CEO's career regardless of the stock price. Moreover, any potential inside information that inside directors use to justify a firing has to reflect negatively on the CEO without reflecting negatively on them. Consistent with this point is evidence from Borokhovich et al. (1996) and Huson et al. (2000), who find that outsider-dominated Boards are more likely than insider dominated Boards to replace a CEO with someone from outside the firm.

Yermack (1996) and Wu (2000) perform a similar analysis of CEO turnover, measuring the impact of Board size on the relationship between CEO turnover and firm performance. Both Yermack and Wu find a positive and significant coefficient on this interaction term, which indicates that firms with smaller Boards have a stronger relationship between firm performance and CEO turnover than firms with larger Boards.

Perry (2000) breaks down the cross-sectional relationship between CEO turnover and firm performance by whether the outside directors are paid using incentives. He finds that the relationship between CEO turnover and firm performance is stronger when Boards have incentives. This finding suggests that providing explicit incentives to directors leads them to make better decisions. It is also consistent with the view that outside directors who receive incentive pay tend to have a professional rather than a personal relationship with the CEO and thus are relatively more independent.

Yet because a Board dominated by a CEO will not monitor regardless of its visible characteristics, we tend to see independence as the true causal variable, with size, compensation, and Board composition as correlates. A Board made up of directors who wish to be independent of management will prefer to be paid with incentives and to arrange themselves, in terms of size and composition, in a way that best facilitates oversight of management.

Another role of the Board is to set and oversee the firm's policies for compensating management. A view, prevalent since at least Berle and Means (1932), is that CEOs exert control or influence over their Boards to extract "excessive" levels of compensation. To examine this view, Core et al. (1999) study the relationships among Board composition, ownership structure, and CEO pay.

Their results suggest that firms with weaker governance structures tend to pay their CEOs more. Specifically, they find that CEO pay rises with the number of outsiders appointed during the CEO's tenure, and about whose appointments the CEO therefore had a say. CEO pay also rises with variables likely to indicate a *lack* of Board involvement: Board size, the number of directors over age sixty-nine, and the number of "busy" directors, where busy is defined in terms of the number of *additional* directorships held by a director.

However, Hermalin and Weisbach's (1998) model predicts that a successful CEO can successfully bargain both for less Board scrutiny *and* greater compensation. That is, the empirical link between an inattentive Board and CEO compensation, which, in a Berle and Means view, is seen as causal, may in fact be spurious: both may be the consequence of a successful CEO exercising his bargaining position (or, correspondingly, an unsuccessful CEO incurring the cost of a reduced bargaining position). In addition, both Core *et al.* (1999) and Hallock (1997) find that CEO pay at a given company increases when the given company's Board contains directors who are CEOs of firms on whose Boards the CEO of the given company sits (that is, when Boards are "interlocking"). Finally, Yermack (1996) finds that the pay-performance relationship for CEOs decreases with Board size, suggesting that small Boards give CEOs larger incentives and force them to bear more risk than do large Boards.

Hermalin and Weisbach (1988) take this approach and estimate the factors that lead to changes in corporate Boards. They find that three kinds of factors are statistically related to changes in the Board. First, poor firm performance increases the likelihood that inside directors will leave the Board and outside directors will join. Second, the CEO succession process appears to be intertwined with the Board-selection process. When a CEO nears retirement, firms tend to add inside directors, who are potential candidates to be the next CEO. Just after a CEO change, inside directors tend to leave the Board, consistent with the hypothesis that these directors are losing candidates to be CEO. Finally, Hermalin and Weisbach document that after a firm leaves a product market, inside directors tend to depart the Board and outside directors tend to join.

Denis and Sarin (1999) confirm these findings on a much larger sample of firms from a nonoverlapping time period. They find that large changes in Board composition tend to occur after abnormally poor performance and around the time of a CEO change. It appears that tightly held firms—in which the founders are still active and the CEO has a large ownership position—tend to have insider dominated Boards. In contrast, larger and older firms are more likely to have professional management with small ownership stakes and outsider-dominated Boards.

Independence from the CEO's influence is the underlying factor in many discussions of Boards and their relationship with management. However, this variable is fundamentally unobservable. A number of recent papers have addressed the power struggle between the Board and CEO empirically in creative ways. Hallock (1997, 1999) examines Board interlocks, which occur when a firm's employee sits on another firm's Board and that firm's employee sits on the first firm's Board. Given this type of relationship, the potential for collusive behavior on the part of the "interlocked" directors is particularly high. Hallock finds that CEOs with interlocking Boards get paid more than otherwise similar CEOs. These findings are consistent with the view that interlocking directorships



provide the CEO a degree of control over his Board or, at the very least, that the CEO has the bargaining power to obtain a friendly Board. Shivdasani and Yermack (1999) examine the extent to which the CEO is involved in the Board-selection process. Shivdasani and Yermack construct a measure of CEO involvement in the selection process based on whether the Board has a separate nominating committee, and conditional on such a committee existing, whether the CEO is on it. The authors find that this measure of CEO involvement decreases the firm's subsequent number of independent directors. Shivdasani and Yermack's results are consistent with the view that, at least in some firms, the CEO is able to use his control over the selection process to decrease the Board's independence.

## 7. Country Level Evidence

Firm-level governance matters, but it may prove hard to correct, at the firm-level, if something is wrong at the country level. The "LLSV" series of papers and related literature provides evidence that a country's overall legal environment, and level of investor protection, correlate with outcomes in securities markets, including equity market size/GDP, number of IPOs, ownership concentration, and dividend policy. However, this literature does not study specific legal reforms and cannot say much about causation, because omitted or general country factors (e.g., civil versus common law) could predict both legal environment and capital market outcomes. It thus leaves open the policy question of the desirability of particular reforms. See, for example, La Porta, Lopes-de-Silanes and Shleifer (2006) and earlier papers by these authors; Durnev and Kim (2005); Doidge, Karolyi and Stulz (2004).

There is also extensive literature using aggregate corporate governance indexes, such as the ISS and the CSLA indexes. Brown and Caylor (2006) show that the ISS index is value relevant in the U.S., and Aggarwal and Williamson (2006) demonstrate that changes in the index are associated with changes in firm value in the U.S. In an international setting, Doidge, Karolyi, and Stulz (2004) show that foreign firms with ADR programs, which differ in governance from other firms from the same country, have higher value. Durnev and Kim (2005) use the CSLA corporate governance ratings and demonstrate that they are value relevant. The CSLA ratings cover 24 emerging countries and newly emerging countries for 2000 and provide ratings for 494 companies. Francis, Khurana, and Pereira (2005) show that disclosure-related governance attributes affect firms' cost of capital across the world. Finally, Dahya, Dimitrov, and McConnell (2006) present evidence that firm value is positively related to Board independence for a sample of firms with a controlling shareholder in countries with poor investor protection.

Doidge, Karolyi, and Stulz (2006) show theoretically and empirically that country characteristics are an important determinant of firm-level governance. The reason for this finding is that the benefits and costs of good governance depend on country characteristics. Firms benefit from good governance because it allows them to access external markets on better terms, but that benefit is not of much value in countries with weak and inefficient capital markets. Good governance is also expected to be cheaper to put in place in countries with better institutions. Aggarwal et al (2007) find that the value of foreign firms increases with the governance gap between the quality of its governance and the governance of a comparable U.S. firm. Board and audit committee independence

emerging as the most valued individual governance attributes. Other attributes, such as the separation of the chairman of the Board and of the CEO functions do not appear to be associated with higher shareholder wealth.

Other studies e.g. Demsetz and Lehn 1985, Boone, *et al.* 2005, Core *et al.* 2005), however, suggest that that these governance mechanisms are endogenously determined. Core, Guay, and Rusticus (2005) find that firms with poor shareholder rights as measured by governance index have significantly negative operating performance but the market is not surprised by the negative performance of poorly governed firms. Lehn, Patro, and Zhao (2005) find that there is no relationship between the governance index and valuation multiples in the 1990s after controlling for valuation multiples in the period from 1980-1985.

## 8. Conclusions

A number of stylized results coming from the empirical literature can be summarized as follows. First, Board composition, as measured by the insider-outsider ratio, is not correlated with firm performance in developed countries, but seems negatively correlated with firm performance in developing countries. However, the number of directors on a firm's Board is negatively related to the firm's financial performance in both types of countries. Second, Board actions do appear to be related to Board characteristics. Firms with *higher proportions of outside directors and smaller Boards* tend to make better -or at least different- decisions concerning executive compensation, and CEO replacement, *ceteris paribus*. Finally, Boards appear to evolve over time depending on the bargaining position of the CEO relative to that of the existing directors. Firm performance, CEO turnover, and changes in ownership structure appear to be important factors affecting changes to Boards.

Several policy recommendations emerge from the review of the literature and evidence from case studies.

First, the importance of introducing a sufficient number of independent directors emerges, even though empowering them to exercise effective monitoring of management may prove a formidable challenge for SOEs. A careful sequencing of corporate governance reforms may prove to be crucial. Introducing independent directors may risk not producing tangible results, if, for instance, the basic Board formal procedures are not in place. More attention to Board selection and evaluation process is essential, among other things to produce the necessary insulation of Board from governmental interference.

Board empowerment requires a number of actions, some of which are outside the control of the companies, and might be facilitated by the government.

- Clarifying the role and responsibility of BoDs, including fiduciary responsibilities (the duty of care, the duty of loyalty, and various other duties) and monitoring of senior management (including the CEO) that directors are expected to carry out through a specific framework that could then be communicated through an awareness and capacity building program;

- Prioritizing the issues that need the attention of the Board to ensure focus on items of material nature and issues related to its governance responsibilities, reducing time consumed with side issues or staff briefings "for information";
- Undertaking Board evaluation to identify existing mix of competences and skills, and specify new profiling for new Board positions;
- Establishing clear terms of reference for Board Committees/ Sub-Committees and how they report to the Board with particular reference to the Audit and HR Committees;
- Undertaking capacity building initiatives for senior management and directors on the required governance changes within the context of unbundled power sector structure;
- Eliminating over time other conflicts of interest inherent in the composition of the Board of Directors, including the introduction of a strict limit to the number of companies in which Board of Directors member can sit;
- Strengthening the process of selection and appointment of BoDs, through structured and skill-based nomination process, transparent and based on merit. Nomination Committees can also be established at the company level or for all SOEs. A database of qualified candidates can also be considered to help enlarging the pool of potential experts for SOE Boards, especially to bring in more private sector experience, thereby improving Boards' professionalism.

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