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ESCOLA DE ADMINISTRAÇÃO DE EMPRESA DE SÃO PAULO

BEATRIZ SCHALKA

Board of Directors and Top Management Team.
A study on CEO relative power and financial return.

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Dissertação apresentada à Escola de Administração de Empresas de São Paulo da Fundação Getúlio Vargas, como requisito para a obtenção de título de Mestre em Administração de Empresas

Campo de Conhecimento:

Gestão Internacional

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“You gotta love living baby... Cause dying is a pain in the ass”

Frank Sinatra

ABSTRACT

Best corporate governance practices published in the primers of Brazilian Securities and Exchange Commission and the Brazilian Corporate Governance Institute promote board independence as much as possible, as a way to increase the effectiveness of governance mechanism (Sanzovo, 2010). Therefore, this paper aims at understanding if what the managerial literature portrays as being self-evident - stricter governance, better performance - can be observed in actual evidence. The question answered is: do companies with a stricter control and monitoring system perform better than others?

The method applied in this paper consists on comparing 116 companies in respect to their independence level between top management team and board directors—being that measured by four parameters, namely, the percentage of independent outsiders in the board, the separation of CEO and chairman, the adoption of contingent compensation and the percentage of institutional investors in the ownership structure – and their financial return measured in terms return on assets (ROA) from the latest Quarterly Earnings release of 2012.

From the 534 companies listed in the Stock Exchange of Sao Paulo – Bovespa – 116 were selected due to their level of corporate governance. The title “Novo Mercado” refers to the superior level of governance level within companies listed in Bovespa, as they have to follow specific criteria to assure shareholders’ protection (BM&F, 2011).

Regression analyses were conducted in order to reveal the correlation level between two selected variables. The results from the regression analysis were the following: the correlation between each parameter and ROA was 10.26%; the second regression analysis conducted measured the correlation between the independence level of top management team vis-à-vis board directors – namely, CEO relative power - and ROA, leading to a multiple R of 5.45%.

Understanding that the scale is a simplification of the reality, the second part of the analysis transforms all the four parameters into dummy variables, excluding what could be called as an arbitrary scale.

The ultimate result from this paper led to a multiple R of 28.44%, which implies that the combination of the variables are still not enough to translate the complex reality of organizations. Nonetheless, an important finding can be taken from this paper: two variables (percentage of outside directors and percentage of institutional investor ownership) are significant in the regression, with p-value lower than 10% and with negative coefficients. In other words, counter affirming what the literature very often portrays as being self-evident – stricter governance leads to higher performance – this paper has provided evidences to believe that the increase in the formal governance structure through outside directors in the board and ownership by institutional investor might actually lead to worse performance.

The section limitations and suggestions for future researches presents some reasons explaining why, although supported by strong theoretical background, this paper faced some challenging methodological assumptions, precluding categorical statements about the level of governance – measured by four selected parameters – and the financial return in terms of financial on assets.

Key words: Corporate governance, control, board of directors, Novo Mercado

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1. INTRODUCTION

Derived from the separation of ownership and control, the principal-agent has arisen as an important issue that organizations face nowadays (Fama & Jensen, 1983). According to the agency theory, it relates to the fact that shareholders from corporations must nominate someone who will supposedly behave on their best interest and, therefore, act in such a way that maximizes shareholders' value (Jensen & Meckling, 1976). However, this situation triggers a number of issues, such as information asymmetry, different risk preferences and wrongly intended behavior.

Bearing in mind this critical situation, corporations have started to find ways to solve or attenuate this problem. The field of Corporate Governance represents the ultimate attempt to protect shareholders' interest from CEOs biased and wrongly intended behavior. Recently, corporate governance topics have received enormous information due to a number of governance failures, including top leading companies in their segments, such as Enron and Parmalat (Cai, Liu, & Qian, 2002).

Derived from corporate governance failures, and supported by theoretical background, many firms have engaged in governance structure systems based on controlling and monitoring, aiming at protecting shareholders' interests. However, as Langevoort (2001) argues, this model of corporate governance has been characterized as largely deficient.

Therefore, the aim of this paper is to examine the relationship between governance structures perceived to be stricter – in respect to the level of control and monitor – and the financial return of the companies. The underlying understanding is that not necessarily more sophisticated governance structures in regard to control will lead to higher financial return, given that some other aspects, such as collaboration and trust among the top management team and the board of directors although crucial, are still neglected (Zahra & Pearce, 1990).

Given the constrain of proving this theory by the affirmative side – in other words, as it would not be feasible in the proposed timeframe to provide evidences to support the relevance of collaboration, as this technique would imply conducting an extensive primary data research (Westphal J. D., 1999) (Siciliano, 2005) – this paper structures its argumentation from the opposite perspective.

Therefore, this paper argues that companies with a more rigid corporate governance structure in respect to control and monitor do not necessarily outperform companies with less rigid corporate governance structure. Best corporate governance practices published in the primers of Brazilian Securities and Exchange Commission (Comissão de Valores Mobiliários, or CVM) and the Brazilian Corporate Governance Institute (Instituto Brasileiro de Governança Corporativa, or IBCG) promote board independence as much as possible, as a way to increase the effectiveness of its governance mechanism (Sanzovo, 2010). Therefore, this paper aims at understanding if what the managerial literature portrays as being self-evident - stricter governance, better performance - can be observed in actual evidence. Thus, the question to be answered is: do companies with a stricter control and monitoring system perform better than others?

The motivation to address this topic comes from the following situation. Many reforms are constantly being imposed and applied all over the world, in respect to establishing corporate governance systems that are offer more protection to shareholders. Some of the proposed reforms consist on limiting the percentage of inside directors, separating the positions of chairman of the board and CEO, imposing age and term limits for directors, increasing the frequency of meetings, among others (Rosenstein & Wyatt, 1990). Many of these improvements have already been established and, yet corrupted behavior and poorly managed firms can be observed, co-existing with what is perceived to be a superior governance structure. This apparent mismatch triggers the question of what element is still missing, so that firms engaged in sophisticated corporate governance structure can actually experience a superior performance.

Bearing this matter in mind and given the wide spectrum of corporate governance structures that companies can deploy, Cai, Lin and Qian (2002) bring up the following question: is governance structure one size fits all? In other words, is it possible to say that a specific governance structure is superior to others and should be implemented in different organizations? This paper does not intend to prove a superiority of one structure when compared to others, but aims at demystifying the long commented superiority of structures that outperform in regards to monitor and control, but not necessarily focus on the strategic service that board should perform (Rosenstein J. , 1987). The primary reason for this is that boards are less likely to exert control over strategic decision making on behalf of shareholders when they lack formal or social independence from management (Westphal & Carpenter, 2001).

Theories of board effectiveness usually attribute weak governance by low level of independence between top management team and board directors. However, according to Westphal and Bednar (2005), the lack of social ties might affect negatively the dynamics of the board. Therefore, the authors suggest that board reforms should place greater emphasis on measures that improve the decision making process and increases the likelihood that directors will actively engage in the decision about the corporate strategy.

The method applied in this paper consists on comparing 116 companies in respect to their independence level between top management team and board directors—being that measured by four parameters, namely, the percentage of independent outsiders in the board, the separation of CEO and chairman, the adoption of contingent compensation and the percentage of institutional investors in the ownership structure – and their financial return measured in terms return on assets (ROA) from the latest Quarterly Earnings release of 2012.

This paper is structured in the following manner: first, it provides an extensive literature review on the relevant topics, namely, agency theory, corporate governance, board of directors and the concept of CEO relative power. Secondly, it explains the methodology and how the data is constructed. Presented that, the paper addresses the results obtained from the data gathering, being the latter structured in three sub sections: sample overview, regression analysis with the developed scale for this paper, and finally regression analysis with the independent variables being transformed into dummy variables. Lastly, conclusions are drawn, as well as the limitations and suggestion for future researches.

2. LITERATURE REVIEW

2.1 Introduction

“Fundamental technological, political, regulatory and economic forces are radically changing worldwide competitive environment” (Fama E. , 1980, p. 831). Given this new environment that companies must face, one single change has created an enormous impact in respect to what it is commonly understood as modern organizations. The separation of ownership and control has deeply affected the paradigm of owner-manager, being it substituted by what we know as professionalized management. Therefore, according to Fama (1980), the agency problem arises exactly from the separation of two functions usually attributed to the entrepreneur, namely risk bearing and management.

Given this basic definition of agency problem, there are many ways to understand this complex relationship between managers and residual claims. Before analyzing them, it is important to point the reasons why agency theory is extremely popular when studying this phenomenon and the challenges from the separation of ownership and control. Firstly, it is very easy to comprehend the complexity of the organization when the latter is reduced to two agents – shareholders and managers. Secondly, given that the agency theory is based on the assumption that individuals are self-interested, it has a strong support from Adam Smith belief, which has been widely spread and accepted throughout the last two centuries (Daily, Dalton, & Canella, 2003).

Given the extensively acceptance of agency theory to explain some organizational phenomenon, such as the universally implementation of board of directors, it will be applied as the core theory throughout this paper. The next section addresses more specifically the agency theory and its implications to modern organizations.

2.2 Agency Theory

The first element to understand the principal-agent problem is grounded on the arena of contractual relationships. As Fama and Jensen (1983) explains, “an organization is the nexus of contracts, written and unwritten, among owners of factors of production and customers” (Fama & Jensen, 1983, p. 302). Namely the “rules of the game” specify the rights of each agent in the organization, establish the performance criteria against which individuals will be appraised and set up the expected payoff for a combination of firm value and observed behavior of each agent.

However, as Fama and Jensen (1983) argue, the main source of agency problems arises exactly because contracts cannot be costlessly written and enforced. In this context, agency costs refer to the lost associated with structuring, monitoring and bonding a set of contracts between agents with conflicting interests. Therefore, as not all the potential situations that may occur when managing a company can be anticipated and included in the contract between managers and owners, there is the inevitable principal-agent problem that must to be solved via different mechanism, such as Corporate Governance instruments (Jensen & Meckling, 1976).

Within this scope, Hart (1995) explains in details that there are three costs that are particularly relevant. First, there is the cost of thinking about all the different eventualities that can occur while the contract is still in vigor. Second, there is the cost of negotiating with others about the contracts. Third, there is the cost of translating contracts into legal objects that could enforced by a third party in the case of a dispute. Therefore, in his understanding, corporate governance is merely “mechanisms for making decisions that have not been specified in the initial contract” (Hart, 1995, p. 680).

Apart from the challenge of anticipating all the possible situations the firm may encounter and writing down an exhaustive contract, there are additional issues from the agent-principal relationship. Even when both parts aim at increasing firm's performance, they very likely have different time horizon preferences, as the agent might want to consume later value added in the short time, increasing his/her compensation in the short time (Walsh & Seward, 1990).

From the perspective that there are innumerable conflicts between the two characters in the context – principal and agent – some researchers have grounded agency theory on instruments that align interests. Jensen and Meckling (1976) understanding is that any managerial behavior can be determined by the incentives provided to the managers. In other words, the authors believe that simple alterations in the wage and incentive package are sufficient to resolve any problem regarding appropriate and expected behavior from the management team. Yet, this theory does not blend closely with reality, as individuals cannot be narrowed down to an economic perspective, and social, political, psychological spheres must also be considered (Daily, Dalton, & Canella, 2003).

According to Eisenhardt (1989), agency theory is concerned with solving two issues. First, it focuses on the fact that the principal cannot closely verify what the agent is doing. The second issue relates to the fact that agent and principal have different risk preferences, and therefore the optimal solution for one might not represent the optimal solution for the other. Therefore, as can be noticed by the nature of the issues, this perspective considers that the most important element is determining the optimal contract between principal and agent. This optimal contract varies according to risk aversion and information level between principal and agent.

However, although mathematically correct in many cases, there are a wide range of shortcomings that is triggered from aligning interests through mainly financial incentives. Firstly, very often there is not a direct and straight link between managers' effort and the

firm performance. In other words, as Shavell (1979) suggests that when there is a noise between manager's marginal product - the expected value from his/her actions cannot be traced unambiguously and costlessly to the manager's actions – risk adverse managers will always choose to share part of the uncertainty in the evaluation of his performance with the firm's risk bearers.

Secondly, CEO's expected behavior cannot always be correctly translated to numbers. Positivist agency theory argues that contracts must be outcome-based, in the sense that executives are compensated according to observed level of outcome. However, as Eisenhadart (1989) explains, there are many pitfalls when this theory is mirrored to the reality. Executives of modern corporations must perform in different directions (socially, financially, environmentally, etc.) and therefore a single measure might be misleading regarding his expected behavior. Additionally, the programmability of the agent's task influence the effectiveness of outcome based contracts. The relationship between programmability and outcome based contract effectiveness is directly proportional, in the sense that the higher the programmability of a specific task, the more effective will be aligning interest trough outcome-based contracts. Bringing this theory to reality, it is comprehensible that outcome-based contracts will not be effective to shape CEOs' behavior, as their task has an extremely low level of programmability and depends on a myriad of aspects, such as world economy, business environment, etc.

Aiming at overcoming all the listed issues related to aligning interests through incentive packages, the third key element of agency theory is observation. The principal, in this context, wants to understand whether the agent is shrinking (referring to the problem of moral hazard, in which managers lack of effort is observable) or striving to achieve positive outcomes. The problem, however, is that the principal will never be able to closely observe the agent so that he/she will feel forced to act according to expected behavior. In other words, he/she can find a way to masked efforts and continue with a shrinking attitude. Therefore, as Eisenhadart (1989) proposes, principals can invest in

information systems, such as budgeting, reporting, etc, to increase vigilance on the agent.

Ultimately, one specific mechanism to monitor and observe executive behavior is the board of directors. This represents a vital part of corporate governance structure. The next section explains Corporate Governance, and clarifies instruments according to their focus, whether internal or external.

2.3 Corporate Governance

Based on the assumption that managers are self-interested and would deviate whenever possible from actions that benefit residual claimants, economists have for a long time struggled to understand how organizations have managed to survive despite the poor and dishonest management. The first plausible suggestion to solve this problem was presented by Jensen and Meckling (1976), who distinctively proposed the initial concept of corporate governance.

The amount of corporate governance research has increased dramatically during the last decade: searching for this term in the Social Sciences Research Network leads to more than 3.500 results. This ultimately shows the increasing relevance that both academic and managerial arenas give to the field corporate governance, as the complex system of rules, laws and mechanisms that aim at protecting shareholders from dishonest management (Gillan, 2006).

Daily, Dalton and Canella (2003) define governance as “the determination of the broad uses which organizational resources will be deployed and the resolution of conflicts among the myriad participants in organizations” (Daily, Dalton, & Canella, 2003, p. 371). Corporate Governance mechanisms aim at assuring to shareholders that managers will

strive to achieve outcomes that are aligned with shareholders' interest (Shleifer & Vishny, 1997).

In a broad definition, according to Jensen (1993), there are four control forces operating on the corporation to resolve the problems caused by conflict of interest between managers and shareholders. They are: (i) legal, political and regulatory systems, (ii) product and factor markets, (iii) capital markets and (iv) internal control systems headed by the board of directors. The author suggests that while the first force is too blunt and cannot resolve properly inefficiencies generated by poor management, the second force is usually too late when disciplines the effects, as very often companies cannot be saved from an imminent failure. Therefore, the field of Corporate Governance focuses exclusively on the third and fourth governance structures, namely internal and external mechanism to protect shareholders' interest.

External mechanisms refer to instruments based on the efficiency of the market, both human and capital markets. Fama (1980) explains that although managers might not suffer a wage alteration in the short-term, the success or failure of companies in the long-run affect how the job market perceives them and, consequentially, adds an extra incentive for managers to behave without opportunistic traces. Therefore, being curtailed from the human capital market, managers have incentives to act on the best interest of shareholders.

Additionally, Fama (1980) argues that shareholders of modern corporations have capital markets on their benefit, as the low cost of shifting capital among firms listed in exchange market allows shareholders to hedge and diversify their holdings across teams. On the other hand, exactly because investors can diversify across management teams, their incentive to closely monitor one specific firm reduces, allowing opportunistic behavior from managers. Moreover, given the easy access to capital markets worldwide, investors very often do not hold the necessary qualifications to monitor the

decision makers and must delegate this function to a qualified third party body control – namely Board of Directors.

An important element of the wide range of external governance mechanism is called hostile takeover, which can be a powerful tool for disciplining management. This instrument consists on allowing players of the market to identify firms that underperform due to poor management decisions and acquire them with the goal of obtaining a large reward. In these circumstances, the management team is not notified about this move and shareholders can shift their capital to a different company, accepting the offer by the bidder (Hart, 1995).

The evolution of an active market for corporate control has been accompanied by an increase in the sophistication and variety of managerial defense tactics against hostile suitors. Walsh and Seward (1990), by pointing out this phenomenon, have indirectly suggested that all the limitation of the current external governance structure, emphasizes the relevance of internal corporate governance protecting mechanisms.

In this context, internal governance mechanisms are the second set of tools that shareholders have at their disposal. Shleifer and Vishny (1997) point out that some internal governance structures are an effectively structured board, compensation packages that align interests and participation of institutional investors in the board. The authors advocate that the most important internal control mechanism is, however, the board of directors, arguing that it is central not only to the role of controlling managers but, also extremely relevant due to its knowledge pool and strategic orientation.

Following Fama's understanding, a natural internal monitoring can also be observed. The author points out that an important characteristic of managers is their ability to elicit and measure the productivity of their team members. Therefore, as individuals are very often appraised according to the performance of the whole group, each member holds an interest on monitoring peers and supervisors. The problem, however, arises when

managers consider that colluding with each other is a more advantageous than competition among them and, in that sense, a third party control mechanism – which can be the case of board of directors - needs to be implemented.

Although the board of director structure is widely perceived to be crucial to the organization, the role of board of directors is still under discussion, both in managerial and academic arenas. Beyond some generally accepted responsibilities, such as hiring and firing CEOs and defining their level of compensation, the participation of the board in regards to strategic orientation of the firm is still under discussion. The next chapter addresses specifically the board of director as a mechanism to protect shareholders and support managerial decisions.

2.4 Board of Directors

In order to understand some point of debate regarding the board of directors, it is useful to adopt Fama and Jensen (1983) decision process framework. Differently than entrepreneurial firms, in which decisions are very often taken by a limited number of people if not a single one, in modern corporations there is a complex decision process. As the authors suggest, it consists basically on four steps: (i) initiation, which refers to proposing resources utilization and structuring contracts; (ii) ratification, which refers to the choice of decisions to be implemented; (iii) implementation and (iv) monitoring, which refers to measuring the performance of the decision agents and implementing rewards.

Having this framework in mind, the relevant questions to be answered are: in which of the four steps should the board of directors take part? Should it focus on the most commented one of monitoring or should it go further and also participate in the initiation and ratification of strategies and decisions?

The authors - Fama and Jensen (1983) - suggest that for an effective system for decision control, the management team should be focused on initiating and implementing, while board of directors – or any third party control body – should allocate efforts to ratify decisions and monitor them. Additionally, Clark (1986) argues that it is still unrealistic to view directors as making a significant impact on business policy decisions. As he says, directors simply approve them and occasionally offer advice or raise probing questions. In the same line of reasoning, Westphal and Fredrickson (2001) believe that while the board of directors is mainly focused on the financial control – as their responsibility is to protect shareholders and assure their financial right – the strategic control is generally reserved for executives. Even though some strategic changes are influenced by the selection of a new CEO – and therefore the board would have greater influence determining the new strategic path – it is widely accepted that boards only ratify decision of managers and very rarely initiate an alteration on their own (Westphal J. D., 1999).

Derived from this situation, many problems arise from the relationship of board of directors and top management team.

Firstly, information asymmetry represents a crucial challenge that needs to be overcome in order to the board be able to perform both counseling and monitoring of the management team. Information asymmetry refers to the fact that boards typically possess far less information than CEOs (Nowak & McCabe, 2003). Therefore, the quality of the information boards hold compared to the quality of information the top management possess can be seen a good predictor for determining the level of monitoring that the first is able to deploy when disciplining the latter. Additionally, given that advice seeking reduces information asymmetry and results in more informed boards (Westphal J. D., 1999), one could assume that boards more engaged in strategic definition tasks could perform better both controlling task – as it has more information – and counseling, as it holds more firm specific knowledge.

In the agency theory, information is regarded as a commodity, in the way that it has a cost and can be purchased (Eisenhadart, 1989). However, as this is clearly not the case in real organizational situations, challenges related from information asymmetry are undeniable. Firstly, given that knowledge is costly to transfer and the whole comprehension of the company and aggregated information for effective decisions are not concentrated in one single person in modern organizations – differently than entrepreneur firms – it leads to ineffective firms' structure and strategic paths. Secondly, managers that are daily immersed in the firm's context will naturally have more information than board members, who participate less frequently. Hence, managers could deviate from the interests of the residual claimants without being easily noticed by the board members.

Alternatively to Fama and Jensen (1983) who categorize boards as either participative or passive, Zahra (1990) presents a full spectrum of possible roles that boards can adopt. According to the author, there are three possible ways to perceive the board of directors. The first, namely "legalistic", understands that the board role is to exclusively protect shareholders and strategy development is seen as exclusive domain of the CEO. In the middle of the spectrum, the second school believes that boards should be active in formulating and implementing strategies, and their functions are to review and evaluate managerial analyses and proposed changes. The third school understands that boards need to go beyond their service and control functions, and a truth partnership between CEO and directors should be built.

Zahra (1990) explains a couple of reasons to support his opinion why boards should further participate in the strategy development. Firstly, Zahra (1990) advocates that boards play an important role as "boundary spanners", in the sense that directors link the company with the external environment. Second, directors' expertise should not be neglected and by exploiting their knowledge from other industries and firms the focal company could leverage its performance. Third, in response to the market pressure, directors should no longer focus on their fiduciary responsibilities without reflecting on

the strategy in place. Lastly, given the increased complexity and competitiveness of the environment, boards are a crucial mechanism to guide CEO on how to deal with this new challenging scenario.

Furthermore, a study conducted by Siciliano (2005) reveals a positive relationship between financial performance of an organization and board involvement in strategic decision making.

Lastly, empirical researchers have often assumed that a lack of social independence from management can compromise board effectiveness in the strategy decision process. Alternatively, Westphal (1999) argues that social ties between top management team and board members may facilitate board involvement by encouraging the provision of advice and counsel in the strategy making process. This process is explained by the fact that when the friendship ties arise, it increases the likelihood that the CEO will seek advice, reassuring board's trust and enhancing the perceived social obligation to provide assistance. In other words, it creates a virtuous cycle which can be extremely beneficial to the overall firm's performance.

Bearing all in mind, the evolution of board's role in more strategic manners is noticeable. Initially, boards were widely perceived as passive, functioning only as rubber stamps of managerial choices (Bavly, 1985). Following a series of corporate bankruptcies in the mid 1970s, and intensifying international competition, the importance of the strategic contribution of boards was reasserted (Zahra & Pearce, 1990).

From this evolution, some drawbacks should also be pointed out. As the board cooperates more closely with the top management team, there are risks associated with entrenchment, lacking independence to successfully monitor executives. Although the board of directors is the ultimate decision body, CEOs and top management team can find shortcuts to influence board members and push decisions that accommodate their

own interests. In other words, there are a numbers of factors that can reduce board power vis-à-vis the CEO. As Westphal (1998) explains, there are informal manners that the management team can entrench the board of directors. Therefore, greater structural board independence may not necessarily enhance board's overall power in relationship with the CEO. As Mowday (1978) noted, individuals compensate for structural disadvantages by making greater use of interpersonal sources of influence.

In conclusion, the challenge between the top management team and the board of directors is to build and maintain trust in their relationship, while also maintaining some distance so that effective monitoring can be achieved (Daily, Dalton, & Canella, 2003).

The next chapter addresses what is called “CEO relative power”, which refers to the power that CEO and top management team can exercise towards board of directors or controlling bodies.

2.5 CEO Relative Power

Corporate governance literature has concentrated much of attention in defining the relative CEO power, as it aims to understand the link between decreasing independence of the board to the firm's performance. In this context, some information is used when assessing the level of independence of the board. Following, four of them are discussed more deeply.

2.5.1 Outside directors

Outside directors refer to executives that are not involved in the daily operations of the company. It is widely agreed that boards with more independent directors have stronger monitoring capabilities (Weisbach, 1988) (Borokhovic & Parrino, 1996) (Fama & Jensen, 1983).

Fama and Jensen (1983) argue that because outside directors have incentives to develop reputation as experts in decision control, they are less likely to collude with internal managers and adopt decisions that deviate from the interest of the residual claimants. In this context, given that their human capital value will depend on the performance of the firms they participate in the board, they have incentives to behave properly. Hence, one could assume that boards composed with more outside directors will perform better monitoring and counseling functions.

However, some authors have tried to break this paradigm, by offering a number of explanations. Hart (1995) argues that given that outside directors do not have a significant financial interest in the company, and would have little to gain from increase in the firm's performance, they are less effective monitors than one would expect. Moreover, outside directors are busy people (Fich & Shivdasanti, 2006) and consequentially do not have the necessary resources to devote to the focal company. Finally, outside directors may owe their position to the management team, and therefore would be highly influenced by the CEO's perspectives.

Zahra and Pearce (1990) point out four – similar - practical limitations that may hinder the strategic involvement of outside directors and, therefore, their perceived value relative to inside directors. Firstly, demands of their other professional responsibilities may make it difficult to devote the necessary amount of time. Second, the risk of interlocking – outside directors adopting a collusive behavior to protect some hidden interest – increases with the representation of more outside directors. Third, since the CEO still plays an important role selecting outside directors, they are not fully independent from the management team. Lastly, it has been observed that when directors face some conflicting view with the management team, they are more inclined to resign instead of confronting.

Westphal and Bednar (2005) approach the ineffectiveness of outside directors from the perspective of pluralistic ignorance. This phenomenon refers to the situation when even

under conditions of low performance, there is a systematic tendency for outside directors to withhold their concerns about the firm and, consequentially, decreases the likelihood of initiating strategic changes in response to low performance. The independent variables, in order to explain pluralistic ignorance, are communication and social integration, both resulting from demographic homogeneity and dense friendship ties among group members. In that sense, it can be understood that having closer social proximity with other members is not always detrimental to the effectiveness of board of directors, but may mitigate the existence of pluralistic ignorance between them.

2.5.2 CEO vs. Chairman

CEO duality occurs when the same person holds both the CEO and the board chairperson positions in a corporation (Finkelstein & D'Aveni, 1994). The most commented aspect about this situation is that CEOs exert excessive influence on boards, what is referred as entrenched boards. It is widely accepted that the separation of the CEO and the chair of the board help to improve board monitoring effectiveness (Klein, 1998) (Jensen M. C., 1993).

However, some authors challenge this common wisdom, by offering some arguments.

Chandler (1962) proposes that there are some advantages related to the situation of CEO duality as, for example, clarifying the decision making authority and sending reassuring signals to stakeholders. Additionally, through the lenses of strategy formation literature, organizations should be headed by strong leaders who set strategic direction, issue command to lower levels and effectively convey messages throughout the whole organization.

This dilemma has been labeled as governance double edge sword. Regarding the balance between collaboration and monitoring, Finkelstein and D'Aveni (1994) acknowledge this challenge and proposes that each organization, depending on the financial, market and a wide range of variables, need to decide whether CEO duality will be beneficial or detrimental to the company. In other words, they argue that when a firm is performing according to stakeholders' expectation, there is less need to create a sense of managerial efficacy and CEO duality is less recommended. On the other hand, when experiencing some financial difficulties, CEO duality can be beneficial to the company as it represents "a captain in charge of the ship" (Finkelstein & D'Aveni, 1994, p. 1086).

Lastly, a study conducted by Brickley, Coles and Jarrel (1997) reached a similar conclusion, in other words, the authors argue that differently from previous empirical works, their evidence suggests that the costs of separation are larger than the benefits for most large firms.

2.5.3 Contingent Compensation

CEO compensation is an important element when aligning interest between shareholders and managers. It is widely accepted that that the higher the contingent compensation (dependent on the performance of the firm), more closely aligned the interests will be (Cai, Liu, & Qian, 2002). In the same line of reasoning, some researches affirm that fixed salaries increase a manager's incentive to deviate from the expected behavior on the job – for instance, consuming perquisites, obstructing a takeover that would benefit shareholders and adapting the level of risk according to his/her preferences. (Beatty & Zajac, 1994) (Westphal & Zajac, 1994).

In that sense, the compensation mix - the level of long term and contingent incentives in a compensation contract - may serve to align the interest of managers with those with shareholders, as it rewards management only on the condition that shareholders benefit from their actions, which means, only if the shareholders returns are enhanced. (David, Kochhar, & Levitas, 1998).

However, as one would expect, this mechanism also presents some drawbacks. Firstly, bonus and variable compensation are very often related to accounting rates, which is susceptible to managerial manipulation. Secondly, although many current adjustments are implemented to improve pay for performance plans – as for instance by deferring a percentage of the bonus for a longer time horizon – the time horizon of principals and agents are still different. Third, this type of contract only focuses on outcomes and, very often, only monetary outcomes. However, they do not explicitly specify and define boundaries of means of achieving such outcomes. Therefore, the adoption of pay for performance contracts could potentially lead to unethical behavior (Eisenhadart, 1989).

There are mainly two approaches to understand top management team compensation: human resources management perspective and agency theory perspective. While the first views managers as critical resources that must be rewarded and retained, the latter emphasizes the need to minimize managerial shirking through monitoring and incentive mechanism (Westphal & Zajac, 1995). Given the latest polemic surrounding CEO compensation, the agency theory logic has become increasingly prevalent in the business press and the organizational literature. Therefore, we can infer that the level and mix of compensation contract plays an important role in signaling to the market the company's effort in protecting shareholders interest, which can be understood as part of the governance communication.

Corroborating the perspective of agency theory, a research has proved a consistently favorable stock market reaction to the announcement of adoption of executive incentive plans based on long term and contingent logics. Westphal and Zajac (1994) have

demonstrated that, as the announcement of long term incentive plans does not guarantee they will be effectively implemented in the company, these instruments very often have a strictly symbolic meaning, being decoupled from the actual compensation practice. From their studies, 45% of the firms that announced a long term incentive plan did not use them, which proves that decoupling in fact exists. As previously pointed, this also refers to the governance communication, which defines how the company conveys messages related to protecting shareholders' interests.

Therefore, it is important to notice some crucial drawbacks related to long term and contingent compensation, both in regards to the decoupling phenomenon and to the incentives problems arisen from the underlying logic of the mechanism of optimal contracts.

2.5.4 Institutional Investor Ownership

The composition of stock ownership at public firms has also changed during the last decade, in particular in respect to institutional investors. Institutional investors are a heterogeneous group of organizations, including banks, public and private pension funds, mutual funds and insurance companies, and they have potentially divergent predilections towards exercising influence. (David, Kochhar, & Levitas, 1998).

The most vocal institutional investor – pension funds – began to actively pressure companies to adopt more instruments that protect shareholders and target poorly performing firms (Huson, Parrino, & Starks, 2001). Despite its role in monitoring managers, some limitations are also observed.

The switching costs faced by institutional investors represent an important incentive for closely monitoring managerial actions. Differently than individual investors that have the option of easily switching their capital to an alternative company, institutional investors high aggregate ownership makes it difficult to sell off their shares in response to poor

performance, as their doing so may adversely affect the stock price (David, Kochhar, & Levitas, 1998).

Although large shareholders might arise as a feasible solution to all the previous commented board structure problems, it also presents some weakness. A large shareholder is very likely to be institutional investors, or in other words, a junction of many smaller inventors, such as a pension fund. Therefore, to the extent that the large shareholder is an institution, the latter must also hire a manager to act on his behalf, creating an additional principal-agent problem (Hart, 1995).

Additionally, as presented by Gillan (2006), institutional investors may be subject to potential conflict of interest with other shareholders and, therefore, their monitoring role is potentially compromised. As some studies conducted in Germany show, by the fact that major institutional investors are banks in the country, they have a very clear conflict of interest with other shareholders, as the risk perception varies greatly. In other words, banks face both the risk of underperforming business and the default risk in respect to the bank lent capital (Morck, Shleifer, & Vishny, 1989).

2.6 Summary Literature Review

Table 1 presents a summary of the main concepts of the literature review, focusing in the ones that are used as ground understanding to discuss the obtained results.

Table 1: Summary of Literature Review

| Summary of Literature Review | | |
|---|--|---|
| Concept | Understanding | Author |
| Interest alignment | When the expected value from manager's actions cannot be traced unambiguously, risk adverse managers choose to share part of the uncertainty in the evaluation of his performance with the firm's risk bearers. | Shavell (1979) |
| Interest alignment | The low programmability and wide range of directions that managers must perform are crucial obstacles when structuring incentives to align interests | Eisenhadart (1989) |
| Information asymmetry | Given that advice seeking reduces information asymmetry, boards more engaged in strategic definition tasks could perform better both controlling task and counseling | Westphal J. D. (1999) |
| Board of Directors | Social ties between top management team and board members may facilitate board involvement by encouraging the provision of advice and counsel in the strategy making process. | |
| Board of Directors | It is widely accepted that boards only ratify decision of managers and very randomly initiate an alteration on their own. | |
| Board of Directors | The most important internal control mechanism is the board of directors: role of controlling managers and knowledge pool & strategic orientation. | Shleifer and Vishny (1997) |
| Board of Directors | positive relationship between financial performance of an organization and board involvement in strategic decision making | Siciliano (2005) |
| Balance between collaboration and control | Challenge between the top management team and the board of directors is to build and maintain trust in their relationship, while also maintaining some distance so that effective monitoring can be achieved | Daily, Dalton, & Canella (2003). |
| Outside directors | Widely agreed that boards with more independent directors have stronger monitoring capabilities | Weisbach (1988) Borokhovic & Parrino (1996) Fama & Jensen (1983). |
| Outside directors | Given that outside directors do not have a significant financial interest in the company, they are less effective monitors than one would expect. | Hart (1995) |
| Outside directors | Busy people who do not have the necessary resources to devote to the focal company. | Fich & Shivdasanti (2006) |
| Outside directors | Pluralistic ignorance: situation when even under conditions of low performance, there is a systematic tendency for outside directors to withhold their concerns about the firm | Westphal and Bednar (2005) |
| CEO vs. Chairman | Widely accepted that the separation of the CEO and the chair of the board help to improve board monitoring effectiveness. | Klein (1998) Jensen M. C. (1993) |
| CEO vs. Chairman | CEO duality clarifies the decision making authority and sends reassuring signals to stakeholders. | Chandler (1962) |
| CEO vs. Chairman | Each organization, depending on the financial, need to decide whether CEO duality will be beneficial or detrimental to the company. When a firm is underperforming: more need to create a sense of managerial efficacy and CEO duality is recommended. | Finkelstein and D'Aveni (1994) |
| Contingent compensation | Fixed salaries increase a manager's incentive to deviate from the expected behavior on the job and adapting the level of risk according to his/her preferences. | Beatty & Zajac (1994) Zajac & Westphal (1994) |
| Contingent compensation | Long term incentive plans are nor always effectively implemented in the company - strictly symbolic meaning, being decoupled from the actual compensation practice | Westphal and Zajac (1994) |
| Institutional investor | A large shareholder is very likely to be institutional investors (creating an additional principal-agent problem) | Hart (1995) |

Source: Data from literature review elaborated by the author

3. METHODOLOGY

3.1 Introduction

In order to reveal evidences that support the hypothesis, 116 companies are assessed. From the 534 companies listed in the Stock Exchange of Sao Paulo – Bovespa – 116 were selected due to their level of corporate governance. The title “Novo Mercado” refers to the superior level of governance level within companies listed in Bovespa, as they have to follow specific criteria to assure shareholders’ protection (BM&F, 2011).

Some of the requirements of the title “Novo Mercado” are: equity composed exclusively by voting shares, board of directors composed by minimum five directors, being 20% independent directors, disclosure of financial statements on a quarterly basis according to an accounting standard, minimum 25% of the shares in the free float market, among others (BM&F, 2011).

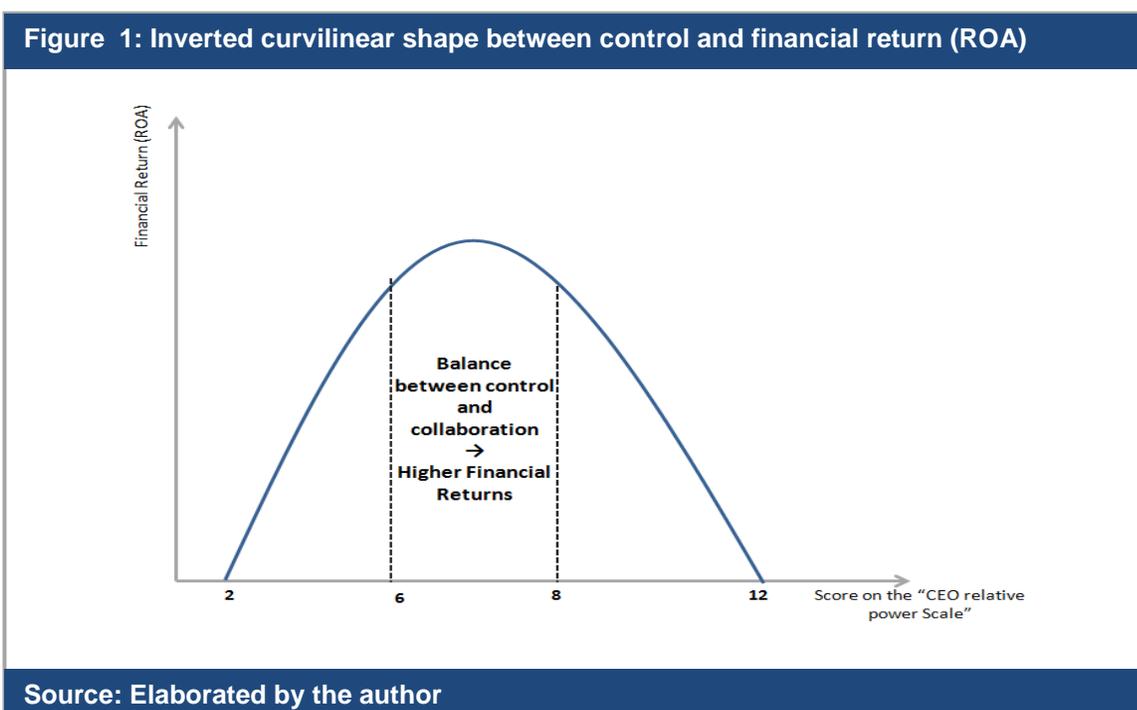
In order to assess the level of control the board of directors has over the management team, the 116 companies are assessed according to four parameters: percentage of independent directors, the separation of chairman and CEO, the adoption of contingent compensation and the percentage of institutional investors in the ownership breakdown. The reasons for selecting specifically these four parameters, as well as the scale applied for each of them are explained in the following section. All the data is public information and was acquired through investor relation websites.

After assessing the companies in respect to these four parameters, companies were scored with final amount of points, which measures the independence level between the top management team and the board of directors. In that way, the final board of directors’ power relative to the CEOs is easily measured in one standardized variable.

The financial return of each firm is measured as the Return on Assets (ROA), from information published in the latest quarterly earnings release in 2012.

The selection of ROA as the financial measure was based on the widely acceptance of this indicator as a short-term performance appraise (Finkelstein & D'Aveni, 1994) (Westphal J. D., 1999) (Westphal & Zajac, 1994). Given that the expected return on assets is highly dependent on the industry that the company operates, the sample of 116 companies was also categorized by industries, being this information obtained by BM&F classification. BM&F categorizes companies by three levels: economic sector, subsector and segment. Therefore, the results analyses are explored from this perspective.

The aggregated score each company can be attributed is between 2 and 12. In the scale, 2 represents the least independent board, while 12 refers to the case in which the board is highly independent from the top management team. More information is provided in the next section, of Parameters and Scale. Given that this paper argues that a balance between collaboration and control between board of directors and top management team leads to higher financial return, inverted curvilinear relationship logic is applied. Figure 1 summarizes this idea.



The curvilinear shape of the scale has been based on an article written by Golden and Zajac (2001), in which the authors advocate that the extremely divided conceptualization of boards as passive or active hides some nuances of the relationship between top management team and board of directors. In other words, depending on the current situation that a company faces at the moment, in respect to the level of monitoring and board strategic involvement, changes such as increasing outside directors and the tenure of the members may be beneficial or detrimental.

Aiming at illustrating this reasoning in a more concrete case, the case of board size is explained. Given that boards can be conceptualized as a group of individuals, one important issue that can affect the working dynamics and contribution is the size (Pearce & Zahra, 1992). There are two opposite bodies of discussion: on one hand some researchers argue that larger boards are able to draw from a larger pool of expertise and, therefore, are more inclined to participate actively. On the other hand, some researchers understand that larger groups suffer a diffusion of responsibility, leading to poor contributions. As both positions have been empirically tested and proved, there are compelling arguments to believe in both logics.

In this respect, Golden and Zajac (2001) proposes that rather than arbitrarily choosing between two compelling arguments, one should consider the possibility of curvilinearity in the relationship between board size and strategic involvement. When board size is very small, the benefits of the breadth of perspectives are significant, but the benefits are subject to diminishing returns as board sizes increases.

Applying this logic into this study, as the advantages and disadvantages of the four chosen parameters (percentage of outside directors, percentage of ownership of outside directors, contingent compensation and CEO vs. Chairman) have been exhaustively discussed and proved in the literature, it is not the intention to choose between two compelling side of arguments. Rather, this study believes that depending on the situation that a specific company faces in respect to monitoring and collaboration

level, structural changes in the corporate governance framework can be either beneficial or detrimental. Therefore, this study also applies a curvilinear relationship (in this case, inverted U shape effects) between level of control and the financial return.

Having scored the companies in respect to the described scale, analyses are performed. The first set of analysis assesses how much the CEO relative power score scale grasps the expected financial return of a company. In other words, two regression analyses are initially conducted, grounded in the developed scale of this paper: firstly, the individual score of each parameter and the financial return measured in terms of ROA; secondly, the CEO relative power score (aggregated score).

Although the scale developed in this paper embraces most of the theoretical background, it is still not able to completely grasp the complex understanding of governance level in business aspect. In other words, some important characteristics of governance structures, such as selection of new CEO (Westphal J. D., 1999); CEO tenure and directors tenure (Zahra & Pearce, 1990); demographic distance (Westphal & Bednar, 2005); and amount and frequency of committee.

In this sense, understanding that the developed scale could not reflect the complex reality within organizations, and therefore it would be already expected a low correlation between the independent and dependent variables, the second part of the analysis consists on dismantling the parameters into dummy variables. The dummy variables applied in the second part of the analysis are presented and explained at the section “Results”, after one has already understood the overall framework of the scale.

3.2 Parameters and Scale

Some detailed information of the scale is provided in this section. It is important to understand that although each parameter contains a specific logic –explained individually in the following section – the aim of attributing each parameter with

maximum three points is to provide the same level of relevance for all, when considering the aggregated CEO relative power scale. In conclusion, as mentioned earlier, the scale varies from two to twelve points, being the latter the situation in which the board is most independent from the CEO and the first situation when the board is least independent from the CEO.

3.2.1 Outside Directors

The portion of the board composed of outside directors represents one dimension of formal structural independence from management (Westphal J. , 1998). While both inside and outside directors are responsible for overseeing and controlling the top management team, several researchers emphasize that outsiders perform more appropriately their role, as they do not hold social ties with the latter (Brudney, 1982) (Fama & Jensen, 1983) (Zahra & Pearce, 1990). However, as Westphal and Bednar (2005) advocate, outside directors may fail yet to actively engage in the support of corporate strategy and decision making process, due to a social distancing resulted from lack of interaction.

Presented this dilemma, the scale for outside directors has been structured in the following manner. The title of “Novo Mercado” imposes that companies’ board have at least 20% of independent outsiders. Therefore, there are 80 points to be distributed accordingly, referring to the percentage between 20% and 100%. In that sense, aiming at providing the same level of relevance as the other parameters, the maximum points attributed will be 3 and the minimum one. The division is presented in table 2.

Table 2: Scale of Percentage of Outside Directors

| % of Outside Directors | Points |
|-------------------------------|---|
| 0 – 20% | Less than minimum required for “Novo Mercado” |
| 21% – 46% | 1 |
| 47% – 73% | 2 |
| 74% - 100% | 3 |

Source: Elaborated by the author

3.2.2 CEO vs. Chairman

The study of CEO duality – referring to the situation in which the chair of the board and the executive command are occupied by the same person - makes it apparent that it is not easy to simultaneously establish unity of command at the top and avoid CEO entrenchment (Finkelstein & D’Aveni, 1994). As the aim of the paper is to examine the extremely hard to balance roles of collaboration and control between board and top management team, this variable certainly seems appropriate.

Following previous work, this variable will be treated as a dichotomous. In that sense, it will be attributed zero point for the situation which the CEO is the chairman and 3 for the opposite situation (Berg & Smith, 1978) (Rechner & Dalton, 1991).

3.2.3 Contingent compensation

Contingent compensation refers to the share of compensation that depends upon the achievement of specific performance goals (Westphal J. D., 1999). Although contingent compensation is likely to align interests between shareholders and top management

team and, therefore, could be seen as an efficient mechanism to reduce agency problems, it also presents some drawbacks. Specifically, linking manager compensation too closely to firm wealth might lead risk avoiding behavior on the part of the agent (Westphal & Zajac, 1994). Therefore, given this tricky situation of determining what is “too closely”, this variable seems to fit the inverted curvilinear shape of the scale.

There is an undeniable challenge when assessing the level of contingent compensation, as it is extremely variable due to changes in the company’s market valuation. For instance, in the case of having stock options, the percentage of the contingent compensation may increase or decrease according to the current market valuation. On the other hand, simply indicating whether the company makes use of contingent compensation as a mechanism to align interest is too superficial, as it does not reveal the level of importance each company attributes to this mechanism. Therefore, given this challenge, an alternative method is applied. Companies are measured in different aspects. Table 3 summarizes the score attributed to each company in respect to contingent compensation. It is important to note that answering according to this system, this parameter also has the same level of relevance, as the maximum is three points.

Table 3 : Scale for Contingent Compensation

| Contingent Compensation | | Points |
|--|-----|---------------|
| Does the company make use of contingent compensation for the CEO? | Yes | 1 |
| | No | 0 |
| Does the company make use of contingent compensation for the directors? | Yes | 1 |
| | No | 0 |
| Does the company disclose the level of contingent compensation in annual reports or other communication vehicle? | Yes | 1 |
| | No | 0 |

Source: Elaborated by the author

3.2.4 Institutional Investor Ownership

Institutional investors are perceived to be an important governance mechanism, as they hold important incentives for closely monitoring managerial actions (David, Kochhar, & Levitas, 1998). On the other hand, there are some drawbacks related to the ownership by institutional investors, such as decrease in liquidity, an additional principal – agent problem and conflict of interest due to risk preferences (Morck, Shleifer, & Vishny, 1989).

Given this dilemma, this parameter also fits the curvilinear shape proposed in this paper. The category of “Novo Mercado” demands that at least 25% of the shares are traded in the free float market. Therefore, there are 75 points, referring to 0% to 75% that can be divided into three equal clusters. In that sense, this parameter also has the same level of importance as the ones before, namely, maximum of three points. Table 4 presents this division.

Table 4: Scale Institutional Investor Ownership

| % of Institutional investor ownership | Points |
|--|--|
| Up to 25% | 1 |
| 26% - 50% | 2 |
| 51% – 75% | 3 |
| More than 75% | Less than minimum required by “Novo Mercado” |

Source: Elaborated by the author

4. Results and Analysis

The research question to be answered in this paper is: do companies with a stricter governance structure in respect to four parameters – percentage of outside directors, the existence of CEO duality, the adoption of contingent compensation for top management team and directors and the percentage of institutional ownership – perform better than companies with a less rigid governance structure?

Having presented the methodology, including the sampling, research procedures and investigation strategies, this chapter analyzes the obtained results. As explained earlier, the companies were compared in respect to four parameters, the selected financial measurement Return on Assets (ROA) and categorized by the industry in which they operate. Therefore, the analysis is structured in the following manner: firstly, it is presented an overview in regard to the sample; secondly, statistics regressions are conducted, in order to assess the level of correlation between the proposed parameters of CEO relative power and the financial return. Thirdly, the parameters are transformed into dummy variables, aiming at understanding which specific variables are able to translate the expected financial return of a company.

4.1 Sample Overview

In total 116 companies were assessed, as they all have been labeled with the title “Novo Mercado” from the terminology of Bovespa. Bovespa also classifies the companies in respect to the industry in which they operate, according to three levels: economic sector, subsector and segment. The breakdown of this categorization is observed in table 5. From analyzing the table 5 it is possible to observe that the most represented economic sector is engineering & transportation, which constitutes 25% of the sample. Non – cyclical consumption, cyclical consumption and Financing & Others

are the second, third and fourth most represented sectors, with 17%, 15% and 15% respectively.

In respect to subsectors, construction & engineering represent 17% of the total sample, being followed by transportation and real estate, with 8% and 7% respectively.

Table 5: Breakdown by Economic Sector and Subsectors

| Economic Sector | No | % Total | Subsectors | No | % Economic Sector | % Total |
|---------------------------------|-----|---------|-------------------------------------|----|-------------------|---------|
| Industrial Goods | 9 | 8% | Electric Equipment | 1 | 11% | 1% |
| | | | Machinery and Equipment | 3 | 33% | 3% |
| | | | Transport Material | 4 | 44% | 3% |
| | | | Services | 1 | 11% | 1% |
| Construction and Transportation | 29 | 25% | Construction and Engineering | 20 | 69% | 17% |
| | | | Transportation | 9 | 31% | 8% |
| Cyclical Consumption | 17 | 15% | Commerce | 6 | 35% | 5% |
| | | | Divers | 4 | 24% | 3% |
| | | | Hotels and Restaurants | 2 | 12% | 2% |
| | | | Leisure | 1 | 6% | 1% |
| | | | Textiles, Clothing and Footwear | 4 | 24% | 3% |
| Non - cyclical Consumption | 20 | 17% | Agricultural | 2 | 10% | 2% |
| | | | Processed Foods | 7 | 35% | 6% |
| | | | Commerce and Distribution | 2 | 10% | 2% |
| | | | Divers | 1 | 5% | 1% |
| | | | Products for Personal Use and Clean | 1 | 5% | 1% |
| Financial and Others | 17 | 15% | Health | 7 | 35% | 6% |
| | | | Real Estate | 8 | 47% | 7% |
| | | | Funds | 1 | 6% | 1% |
| | | | Diversified Holdings | 1 | 6% | 1% |
| | | | Security and Insurance | 2 | 12% | 2% |
| Basic Materials | 7 | 6% | Financial Services | 5 | 29% | 4% |
| | | | Wood and Paper | 2 | 29% | 2% |
| | | | Various Materials | 2 | 29% | 2% |
| | | | Mining | 1 | 14% | 1% |
| | | | Chemicals | 1 | 14% | 1% |
| Oil & Gas | 4 | 3% | | | | |
| Information Technology | 4 | 3% | Steel & Metals | 1 | 14% | 1% |
| | | | Oil & Gas | 4 | 100% | 3% |
| Telecommunications | 1 | 1% | Computers and Equipment | 2 | 50% | 2% |
| | | | Programs and Services | 2 | 50% | 2% |
| Public Utility | 8 | 7% | Mobile | 1 | 100% | 1% |
| | | | Water and Sewage | 2 | 25% | 2% |
| Total | 116 | 100% | Electricity | 6 | 75% | 5% |

Source: Data from Bovespa elaborated by the author

Table 6 presents a summary of the average score – CEO Relative Power – of the companies categorized by economic sectors, as well as the standard deviation.

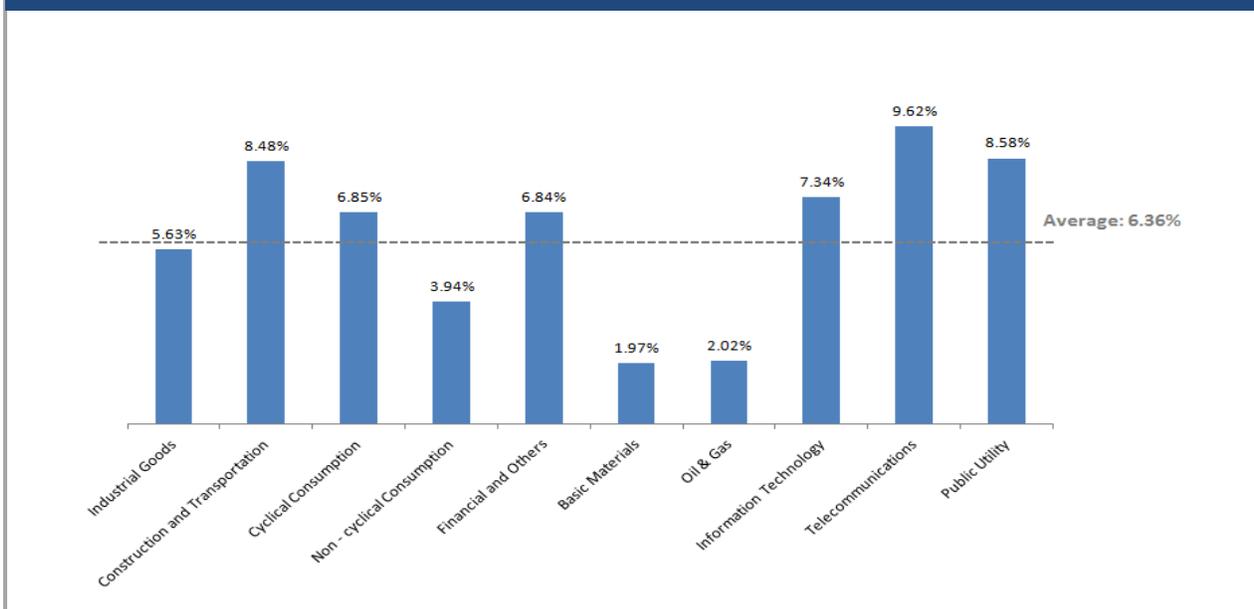
Table 6: Average Score and CEO relative Power per Economic Sector

| Economic Sector | Average ROA | Average Total Score CEO Relative Power | Standard Deviation Total Score |
|---------------------------------|--------------|--|--------------------------------|
| Industrial Goods | 5.63% | 8.22 | 1.85 |
| Construction and Transportation | 8.48% | 7.37 | 1.87 |
| Cyclical Consumption | 6.85% | 7 | 2.29 |
| Non - cyclical Consumption | 3.94% | 7.75 | 1.86 |
| Financial and Others | 6.84% | 7.76 | 2.43 |
| Basic Materials | 1.97% | 7.57 | 1.91 |
| Oil & Gas | 2.02% | 8.75 | 2.21 |
| Information Technology | 7.34% | 8 | 1.82 |
| Telecommunications | 9.62% | 7 | - |
| Public Utility | 8.58% | 7.75 | 1.98 |
| Total | 6.36% | 7.61 | 2.07 |

Source: Based on secondary data gathering elaborated by the author

By analyzing table 6 and figure 2, it is possible to observe that telecommunications presents the highest ROA with 9.62%, followed by public utility, construction & engineering and financial & others, with 8.58%, 8.48% and 6.84%. On the other hand, figure 2 presents that non-cyclical consumption, basic materials and gas & oil underperform when compared to the sample average.

Figure 2: Return on Assets by Economic Sector



Source: Based on secondary data gathering elaborated by the author

In respect to the total score CEO relative power, oil & gas presents the highest score, followed by industrial goods with 8.22. In the sequence, three economic sectors – non-cyclical consumption, financial & others and public utility – have very similar scores around 7.75. From figure 3 it is notorious how the overall sample is extremely homogenous in respect of the level of governance control, measured in terms of the CEO relative power. This phenomenon is further explained, as it seems to have an impact in the final conclusion of this paper.

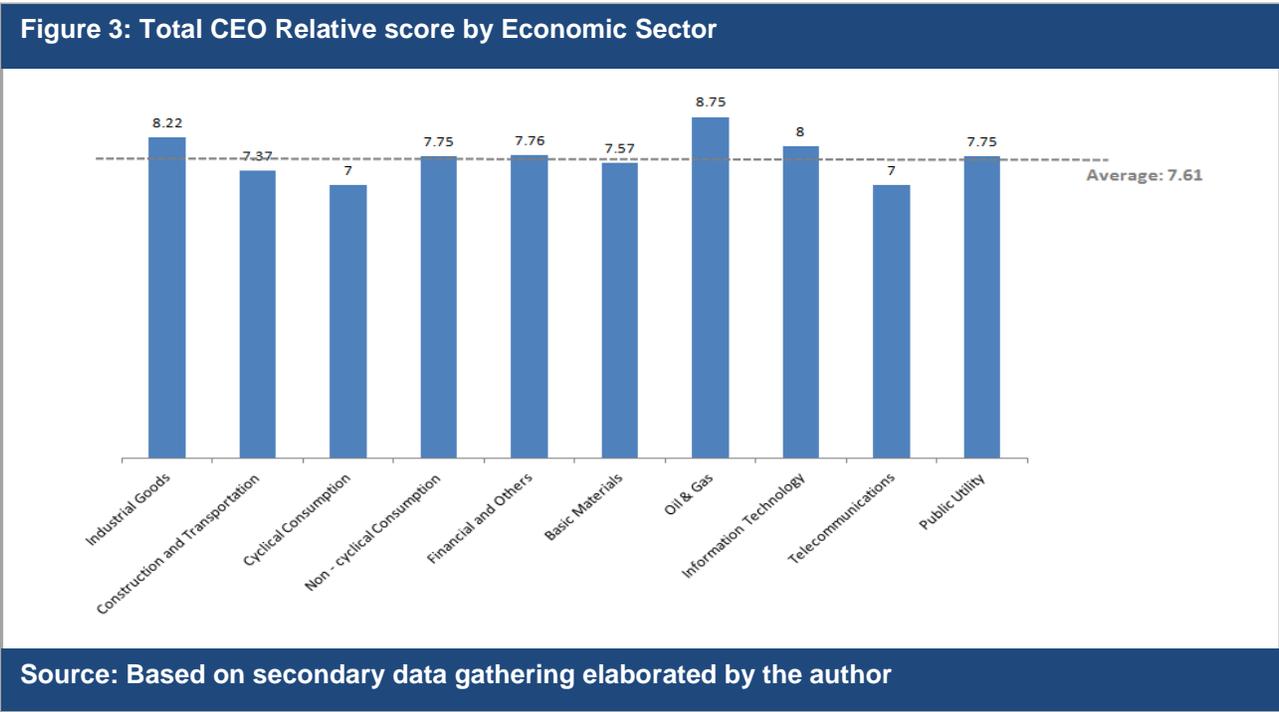


Table 7 and figure 4 present the distribution in respect of the CEO relative power. As it can be noticed, the sum of companies that have scored between 6 and 8 (as this range was considered the ideal balance in terms of collaboration and control) is 45.7%. In that way, almost half of the sample could be accounted in the ideal range. Therefore, as it

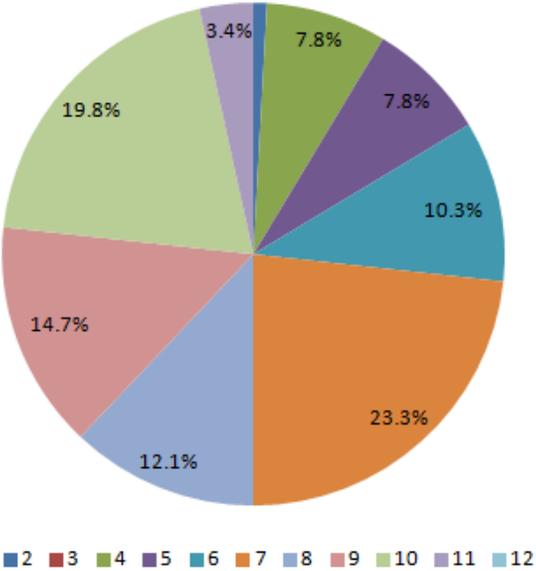
has been touched upon before and is further analyzed in the chapter of statistics regression, creates some obstacles to draw conclusions about this topic.

Table 7: Distribution CEO Relative Power Score

| Distribution CEO Relative Score | | |
|---------------------------------|----|-------|
| Score | No | % |
| 2 | 1 | 0.9% |
| 3 | 0 | 0.0% |
| 4 | 9 | 7.8% |
| 5 | 9 | 7.8% |
| 6 | 12 | 10.3% |
| 7 | 27 | 23.3% |
| 8 | 14 | 12.1% |
| 9 | 17 | 14.7% |
| 10 | 23 | 19.8% |
| 11 | 4 | 3.4% |
| 12 | 0 | 0.0% |

Source: Based on secondary data gathering elaborated by the author

Figure 4: Distribution CEO Relative Power Score



Source: Based on secondary data gathering elaborated by the author

The standard deviation of the CEO relative power provides some interesting insights in respect of the homogeneity of the sample. As it can be observed, industrial goods companies are the most homogenous among each other (lowest standard deviation), while financial & others are the most heterogeneous.

Table 8 comprises an extensive analysis of the results of the four measured parameters of CEO relative power. The percentage of independent outsiders already sends a clear message, as the vast majority of the companies - 83.6% - adopt between 21% and 46% of the outsiders. In that way, they only operate one level above the required percentage of 20% and fifteen percentile points, given that the overall average of independent outsiders is 35%. From this initial understanding, it is possible to affirm that given the already strict rules imposed by the category “Novo Mercado”, companies very rarely push beyond this level. In other words, they do not overemphasize corporate governance as a mechanism to further protect shareholders’ interest or increase the financial return, but they are rather shaped by the regulatory system.

In respect to the existence of CEO duality, almost three quarters of the companies do not hold a situation in which the CEO also performs the role of chairman of the board. The case of CEO duality most commonly happens in partially owned family companies, such as Arezzo, Cia Hering and JHSF Participações. The literature proposes that CEO duality can be beneficial when the company is facing a difficult financial situation, as this sends a message to the market of who is in charge of the “ship” (Finkelstein & D’Aveni, 1994) (Chandler, 1962). However, at this point it is important to note that the average return on assets performed by the cluster of companies that hold a CEO duality is 6.22%, while the overall average is 6.36%. Therefore, this argumentation does not seem to apply here.

Contingent compensation is an additional mechanism to align top management team interests and shareholders' interests. The sample illustrates that this tool is widely applied for both CEOs and directors: 60% and 56%, respectively, of the companies use contingent compensation for chief executive officers and directors. In respect to disclosing the level of contingent compensation – usually published in annual reports and in the ownership breakdown, in cases in which the top management team and directors hold a part of the shares – 70% of the companies adopt this practice.

A more interesting analysis of the adoption of contingent compensation occurs when aggregating the answer of the three questions, so it is possible to observe how companies behave simultaneously to these three matters. In that sense, almost one quarter of the sample do not adopt any of these practices, namely, using contingent compensation for CEOs, directors and disclosing the level of contingent compensation adopted. Figure 8 illustrates that 24% of the companies scored zero points. One level up, there are 18% of the companies that have been assessed with one point, which means that out of the three potential practices from contingent compensation, they adopt one of them. The number of companies with two points in this parameter calls attention: only 6% of sample has been scored two points, which implies that a normal distribution cannot be observed in this parameter. Lastly, slightly over the majority of the companies scored 3 points, which means that they adopt contingent compensation for CEOs, directors and also disclose the level of compensation applied in each case. It is noteworthy that three quarters of the sample scored in the extremes of the scale – either zero or three points – triggering the question of whether companies perceive the value of contingent compensation only when the mechanism is fully put in practice.

Additionally, Westphal and Zajac (1994) argued that the phenomenon of institutionalization can be observed in respect to contingent compensation, referring to the fact that these practices provide legitimacy. In that way, many companies adopt contingent compensation practices seeking for legitimacy, rather than considering technical improvements (Zucker, 1977). In that way, bearing in mind the two extremes

that companies operate (either scoring zero or three points in this parameter), it seems that this Zucker's theory can be observed.

It has been expressed that contingent compensation – especially in the form of long term incentive plan (LTIP) – is more efficient and should be further applied when the financial performance is different than the expected one (Beatty & Zajac, 1994). In that sense, we could assume that the financial return for the cluster of companies that scored three points in this parameter is lower than the financial return of companies that score zero points. From looking at table 9, this trend is observed in the sample. However, it is important to bear in mind that given some sample limitation – the amount of companies that scored three is more than the double than the amount of companies that scored zero – statically it is not possible perform a test to prove this hypothesis.

Lastly, the parameter of percentage of institutional investor indicates that 64% of the sample holds ownership structures that are on the upper limit allowed by Bovespa. According to “Novo Mercado” rules, companies are required to have at least 25% of the shares in the free floating market. This requirement is based on the logic that liquidity is highly important to stock exchanges, as it attracts more capital and investors, boosting the country's economy (BM&F, 2011). The average of the cluster of companies that scored three in this parameter is 65%, while the overall average of the sample is 61%. On the other extreme, it is noteworthy that less than 5% of the companies adopt a less concentrated capital structure, in the case of having less than 25% of the capital represented by institutional investors.

Some anecdotes observation point to the fact that companies that have a concentrated capital structure are very often partially family owned. Some examples are: JHSF Participações, Cia Hering, Diagnostico da America S.A (DASA) among others.

Table 8: Overview CEO Relative Power – Per Parameter

| Overview CEO Relative Power | | |
|--|----|-------|
| % Independent Outsiders | | |
| Range | No | % |
| 21% - 46% | 97 | 83.6% |
| 47% - 73% | 17 | 14.7% |
| 74% - 100% | 2 | 1.7% |
| CEO Duality | | |
| Question | No | % |
| No | 84 | 72.4% |
| Yes | 32 | 27.6% |
| Contingent Compensation | | |
| Question | No | % |
| Does the company make use of contingent compensation for the CEO? | | |
| Yes | 70 | 60.3% |
| No | 46 | 39.7% |
| Does the company make use of contingent compensation for the directors? | | |
| Yes | 65 | 56.0% |
| No | 51 | 44.0% |
| Does the company disclose the level of contingent compensation in annual reports or other communication vehicle? | | |
| Yes | 80 | 69.0% |
| No | 36 | 31.0% |
| Total Score | | |
| 0 | 28 | 24.1% |
| 1 | 21 | 18.1% |
| 2 | 7 | 6.0% |
| 3 | 60 | 51.7% |
| % Institutional Ownership | | |
| Range | No | % |
| Up to 25% | 5 | 4.3% |
| 26% - 50% | 26 | 22.4% |
| 51 - 75% | 74 | 63.8% |

Source: Based on secondary data gathering elaborated by the author

Table 9: Comparison between score contingent compensation and Average ROA

| Score Contingent Compensation vs. Average ROA | |
|---|------|
| Score | ROA |
| 0 | 6.9% |
| 3 | 5.8% |

Source: Based on secondary data gathering elaborated by the author

4.3 Regression Analysis of CEO Relative Power - Per Parameter & Aggregated Score

Having presented an extensive overview of the sample in respect to the four parameters, this section aims that conducting some regression analysis between the selected variables. The goal is to assess the level of correlation between two selected variables. In this section, two main regression analyses are performed: firstly, the individual score of each parameter and the financial return measured in terms of ROA; secondly, the CEO relative power score (aggregated score) and the financial return measured in terms of ROA.

In both of the regression analyses, apart from assessing how much the governance parameters are significant to explain financial return, the variable total assets is added, aiming at understanding whether the size of the company has an impact in the governance level. This latest suggestion has support from the theoretical background, as previous researches have argued that given the higher information asymmetry that larger companies face – as they tend to be more mature, with well established disclosure policies and practices, receiving more attention from the market and regulators – they also engage in more sophisticated governance practices as a way to attenuate this problem (Cai, Liu, & Qian, 2002).

Before starting these statistics analyses, it is important to define some basic concepts of this tool. The regression analysis was conducted using the tool presented in Microsoft Excel, version 2012. Although the outcome table of regressions contains a wide range of statistics, for the purpose of this paper, two outputs are analyzed: multiple R, which explains the fraction of the variation in y – in this case financial return or total assets - that is explained by the variables in the equation – as for instance the four selected parameters – and the p-value, which express whether the independent variable is statistically expected to explain the dependent variable, given the significance level of 10% in this case (Bernstein & Bernstein, 2005).

4.3.1 Regression ROA vs. CEO Relative Power – Per Parameter

From observing table 10, some conclusions can be drawn in respect to the level of correlation between each parameter and the financial return measured in terms of ROA. The table illustrates that the multiple R resulted in 10.26%, which means that the combination of the four selected parameters and company's size – percentage of outside investors, CEO duality, adoption of contingent compensation and percentage of institutional investor and total assets – explains the financial return slightly more than 10%.

At this point, it is possible to affirm that this multiple R presents a first understanding that, given the methodology applied – in respect to parameters, sample and scale – the research question cannot be answered categorically.

This paper ultimate goal is to construct a solid base of evidences that could lead researchers to believe that companies with stricter governance structures would not have necessarily higher returns than companies with less rigid governance structure. By analyzing the obtained p-values it is possible to affirm that all the five hypothesis tests,

in other words, the hypothesis that these five variables could explain financial return, were rejected with a significance level of 10%.

Table 10: Regression Analysis: ROA vs. CEO Relative Power – Per Parameter

| Regression: ROA vs. CEO Relative Power - Per Parameter | | | | | | | | |
|--|--------------|----------------|-------------|-------------|----------------|-----------|-------------|-------------|
| Regression Statistics | | | | | | | | |
| Multiple R | 10.2631% | | | | | | | |
| R Square | 1.0533% | | | | | | | |
| Adjusted R Square | -3.444% | | | | | | | |
| Standard Error | 0.092459822 | | | | | | | |
| Observations | 116 | | | | | | | |
| ANOVA | | | | | | | | |
| | df | SS | MS | F | Significance F | | | |
| Regression | 5 | 0.010010513 | 0.002002103 | 0.234196403 | 0.946726866 | | | |
| Residual | 110 | 0.940370055 | 0.008548819 | | | | | |
| Total | 115 | 0.950380568 | | | | | | |
| | Coefficients | Standard Error | t Stat | P-value | Lower 95% | Upper 95% | Lower 95.0% | Upper 95.0% |
| Intercept | 0.076 | 0.042 | 1.814 | 7.2% | -0.007 | 0.159 | -0.007 | 0.159 |
| Total Assets | 0.000 | 0.000 | -0.443 | 65.9% | 0.000 | 0.000 | 0.000 | 0.000 |
| Score outsiders | -0.012 | 0.021 | -0.558 | 57.8% | -0.052 | 0.029 | -0.052 | 0.029 |
| Score CEO duality | 0.001 | 0.007 | 0.113 | 91.0% | -0.012 | 0.014 | -0.012 | 0.014 |
| Score Compensation | -0.004 | 0.007 | -0.582 | 56.2% | -0.017 | 0.009 | -0.017 | 0.009 |
| Score Institutional Investors | 0.004 | 0.009 | 0.445 | 65.8% | -0.014 | 0.022 | -0.014 | 0.022 |

Source: Based on secondary data gathering elaborated by the author

4.3.2 Regression ROA vs. CEO Relative Power

The second regression analysis conducted measures the correlation between the total CEO relative power score and the financial return measured in terms of ROA. It is important to notice that this analysis differs from the previous one in the sense that the relative power score is considered in its aggregated score, and not individually per parameter anymore.

This regression (Table 11) leads to even multiple R (5.45%), which implies that the overall CEO relative power scale does not closely explain return on assets in this sample. Moreover, the high p-value of the CEO relative score (aggregate value) demonstrates that this scale do not encompasses the complexity of organizations.

Table 11: Regression Analysis: ROA vs. CEO Relative Score

| Regression: ROA vs. CEO Relative Power | | | | | | | | |
|--|--------------|----------------|-------------|-------------|----------------|-----------|-------------|-------------|
| Regression Statistics | | | | | | | | |
| Multiple R | 5.4580% | | | | | | | |
| R Square | 0.2979% | | | | | | | |
| Adjusted R Square | -1.467% | | | | | | | |
| Standard Error | 0.091571793 | | | | | | | |
| Observations | 116 | | | | | | | |
| ANOVA | | | | | | | | |
| | df | SS | MS | F | Significance F | | | |
| Regression | 2 | 0.00283112 | 0.00141556 | 0.168812602 | 0.844879799 | | | |
| Residual | 113 | 0.947549448 | 0.008385393 | | | | | |
| Total | 115 | 0.950380568 | | | | | | |
| | Coefficients | Standard Error | t Stat | P-value | Lower 95% | Upper 95% | Lower 95.0% | Upper 95.0% |
| Intercept | 0.071 | 0.033 | 2.108 | 3.7% | 0.004 | 0.137 | 0.004 | 0.137 |
| Total Assets | 0.000 | 0.000 | -0.547 | 58.5% | 0.000 | 0.000 | 0.000 | 0.000 |
| Total Score | 0.000 | 0.004 | -0.109 | 91.4% | -0.009 | 0.008 | -0.009 | 0.008 |

Source: Based on secondary data gathering elaborated by the author

However, at this point it is extremely important to point out some limitations of the methodology – especially the sample - which might be a potential cause to such small multiple R. As presented in the section “Sample overview”, the sample is extremely homogenous in respect to total CEO relative power score, with half of the universe being classified in the ideal range – between 6 and 8 – that indicates balance collaboration and control. In addition, when classified by the economic sector determined by Bovespa, it is noteworthy that clusters of companies are extremely similar as well, which creates an obstacle to further analyze the research question by industries.

Therefore, as the variable of total CEO relative score is extremely similar among companies and economic sectors, is it difficult to draw conclusions in respect to the impact of the governance level on financial return. As it is discussed in the section limitations and suggestions for future researches, a potential way to attenuate this problem would be by adopting a sample composed not only by the group “Novo Mercado”, but also Level 1 and Level 2 according to the terminology of Bovespa. Further details of this alternative are provided in the next section.

4.4. Regression Analysis – With dummy variables

The previous section has showed that considering the developed scale for this paper, no evidence could be found to support the belief that companies with stricter governance level outperform companies with less rigid governance control. This section, on the other hand, analyzes the data in a different way, leading to alternative conclusions.

As mentioned before, the scale is a simplification of the reality, in two different ways. Firstly, it only encompasses four parameters of governance level, given that the highly complex governance system could not be translated into one single measure – CEO relative power. Secondly, the scale applied for two of the parameters - percentage of outside directors and percentage of institutional investor ownership – leaves room for discussion, as one could say that the scores attributed to the companies (from zero to three points, according to the percentile observed) is not fully supported by the literature review and, therefore, is arbitrarily chosen.

Given this situation, the second part of the analyses transforms all the four parameters into dummy variables, excluding what could be called as an arbitrary scale. The next section explains all the dummy variables used in the second set of regression analysis.

4.4.1 Parameters in Dummy Variables

4.4.1.1 Outside Directors

The title of “Novo Mercado” imposes that companies’ board have at least 5 board members, being 20% of independent outsiders. Therefore, translating these requirements into dummy variables, the questions to be answered to each company are presented in table 12

Table 12: Scale of Percentage of Outside Directors as Dummy Variables

| Board of Directors | | Points |
|---|-----|--------|
| Is the company’s board composed by 5 members? | Yes | 1 |
| | No | 0 |
| Is the company’s board composed by 20% independent directors? | Yes | 1 |
| | No | 0 |
| Is the company’s board composed by the majority of outsiders? (% outsiders > % of insiders) | Yes | 1 |
| | No | 0 |

Source: Elaborated by the author

4.4.1.2 CEO vs. Chairman

As already adopted in the earlier section, this variable is treated like a dichotomous. Table 13 illustrates the logic of this dummy variable.

Table 13: CEO vs. Chairman as Dummy Variable

| CEO vs. Chairman | | Points |
|--|-----|--------|
| Does the CEO also occupy the position of chair of the board? | Yes | 1 |
| | No | 0 |

Source: Elaborated by the author

4.4.1.3 Contingent compensation

The parameter of contingent compensation has also been already treated like dummy variables in the previous section, in the sense that the score of the scale was the output of three yes/no questions. Therefore, for this second part of analysis, the same three questions are considered. Table 14 recapitulates them.

Table 14 : Contingent Compensation as Dummy Variables

| Contingent Compensation | | Points |
|--|-----|--------|
| Does the company make use of contingent compensation for the CEO? | Yes | 1 |
| | No | 0 |
| Does the company make use of contingent compensation for the directors? | Yes | 1 |
| | No | 0 |
| Does the company disclose the level of contingent compensation in annual reports or other communication vehicle? | Yes | 1 |
| | No | 0 |

Source: Elaborated by the author

4.4.1.4 Institutional Investor Ownership

According to Novo Mercado rules, there is only one requirement in respect to the percentage of institutional investor ownership, as it imposes that at least 25% of the shares have to be traded in the free floating market. Apart from the requirement of Novo Mercado, an important point of ownership structure to any listed company is whether the majority shareholder possesses more than 50% of the capital, as this would tone down the aspect of True Corporation and, therefore, impact the governance structure of the focal company. Table 15 summarizes the dummy variables for this parameter.

| Table 15: Institutional Investor as Dummy Variables | | |
|--|-----|--------|
| Institutional Investor | | Points |
| Does the company have 75% of its capital owned by institutional investor? | Yes | 1 |
| | No | 0 |
| Does the majority institutional investor own more than 50% of the capital? | Yes | 1 |
| | No | 0 |

Source: Elaborated by the author

4.4.2 Regression Analysis – with all Dummy Variables

As the scale was not able to grasp the complexity of governance mechanisms in real organizations, the second part of the analyses dismantles the parameters into several

dummy variables. The first regression conducted included all the dummy variables recently explained, plus the total assets. Table 16 presents the results.

Table 16: Regression Analysis with all Dummy Variables

| Regression Analysis - With all Dummy Variables | | | | | | | | | |
|--|--------------|----------------|-------------|-------------|----------------|-----------|-------------|-------------|--|
| Regression Statistics | | | | | | | | | |
| Multiple R | 35.5524% | | | | | | | | |
| R Square | 12.6397% | | | | | | | | |
| Adjusted R Square | 1.506% | | | | | | | | |
| Standard Error | 0.0902206 | | | | | | | | |
| Observations | 116 | | | | | | | | |
| ANOVA | | | | | | | | | |
| | df | SS | MS | F | Significance F | | | | |
| Regression | 13 | 0.120125386 | 0.009240414 | 1.135219965 | 0.338972134 | | | | |
| Residual | 102 | 0.830255182 | 0.008139757 | | | | | | |
| Total | 115 | 0.950380568 | | | | | | | |
| | Coefficients | Standard Error | t Stat | P-value | Lower 95% | Upper 95% | Lower 95,0% | Upper 95,0% | |
| Intercept | 0.145 | 0.134 | 1.076 | 28.4% | -0.122 | 0.411 | -0.122 | 0.411 | |
| LN(Total Assets) | 0.004 | 0.008 | 0.447 | 65.6% | -0.012 | 0.020 | -0.012 | 0.020 | |
| % Independentes | -0.104 | 0.135 | -0.773 | 44.1% | -0.371 | 0.163 | -0.371 | 0.163 | |
| Board composed by 5 directors? | -0.052 | 0.032 | -1.647 | 10.3% | -0.114 | 0.011 | -0.114 | 0.011 | |
| Board composed by 20% outside directors? | 0.078 | 0.040 | 1.945 | 5.5% | -0.002 | 0.158 | -0.002 | 0.158 | |
| % outsiders > % insiders | 0.018 | 0.048 | 0.372 | 71.1% | -0.078 | 0.113 | -0.078 | 0.113 | |
| CEO = Chairman | 0.012 | 0.021 | 0.563 | 57.4% | -0.029 | 0.052 | -0.029 | 0.052 | |
| Contingent Compensation CEO | 0.007 | 0.033 | 0.211 | 83.3% | -0.059 | 0.073 | -0.059 | 0.073 | |
| Contingent Compensation Directors | -0.029 | 0.036 | -0.801 | 42.5% | -0.102 | 0.043 | -0.102 | 0.043 | |
| Disclose Compensation Scheme | -0.009 | 0.025 | -0.367 | 71.5% | -0.060 | 0.041 | -0.060 | 0.041 | |
| Institutional Investors | -0.156 | 0.073 | -2.146 | 3.4% | -0.300 | -0.012 | -0.300 | -0.012 | |
| Most represented institutional investor | -0.030 | 0.095 | -0.312 | 75.6% | -0.218 | 0.159 | -0.218 | 0.159 | |
| Only 25% are in the free float? | 0.027 | 0.029 | 0.931 | 35.4% | -0.030 | 0.084 | -0.030 | 0.084 | |
| More than 50% concentrated in one institutional investor | 0.031 | 0.037 | 0.853 | 39.6% | -0.041 | 0.104 | -0.041 | 0.104 | |

Source: Elaborated by the author

From observing the table 16, a couple of comments can be drawn. Firstly, despite the significant increase in the result of Multiple R, it is still low (35.55%) in statistics terms. Another important point to mention is that among the thirteen variables included in this regression (ten dummy variables and three continuous variables), only two presented a p-value lower than 10%, the significance level adopted to test the hypothesis. In this sense, only the variables “board composed by 20% of independent directors” and the “percentage of institutional investor” were meaningful in statistics terms to explain the financial return.

However, it is important to highlight that multicollinearity is observed among a couple of variables, being it a statistical phenomenon in which two or more independent variables in a multiple regression model are highly correlated and, therefore, it impacts the results of the analysis.

The problem of multicollinearity refers specifically to the parameter contingent compensation. As presented in table 8, most of the companies are positioned in the two extremes of the scale, as they have scored either zero or three points in this parameter. This particular distribution suggests that companies tend to adopt either all or none of these practices and, therefore, there is multicollinearity among them. Aiming at improving the model, only one of these dummy variables previously adopted is used (does the company make use of contingent compensation for CEOs?).

4.4.3 Regression Analysis – With Selected Dummy Variables

Excluded some of the problems observed in the previous regression analysis, table 17 presents the results of the regression analysis with selected dummy and continuous variables.

Table 17: Regression Analysis with Selected Dummy Variables

| Regression Analysis - With Selected Dummy Variables | | | | | | | | | |
|--|---------------|-------------|-------------|-------------|-------------------|----------------|----------------|----------------|--|
| Estatística de regressão | | | | | | | | | |
| R múltiplo | 28.4473% | | | | | | | | |
| R-Quadrado | 8.0925% | | | | | | | | |
| R-quadrado ajustado | -0.661% | | | | | | | | |
| Erro padrão | 0.091207308 | | | | | | | | |
| Observações | 116 | | | | | | | | |
| ANOVA | | | | | | | | | |
| | gl | SQ | MQ | F | F de significação | | | | |
| Regressão | 10 | 0.076909393 | 0.007690939 | 0.924528076 | 0.513913757 | | | | |
| Resíduo | 105 | 0.873471175 | 0.008318773 | | | | | | |
| Total | 115 | 0.950380568 | | | | | | | |
| | Coefficientes | Erro padrão | Stat t | valor-P | 95% inferiores | 95% superiores | Inferior 95,0% | Superior 95,0% | |
| Interseção | 0.223 | 0.056 | 3.956 | 0.0% | 0.111 | 0.335 | 0.111 | 0.335 | |
| Setor Financeiro | 0.006 | 0.025 | 0.254 | 80.0% | -0.043 | 0.055 | -0.043 | 0.055 | |
| Total Assets | 0.000 | 0.000 | -0.677 | 50.0% | 0.000 | 0.000 | 0.000 | 0.000 | |
| % Independentes | -0.225 | 0.117 | -1.913 | 5.8% | -0.457 | 0.008 | -0.457 | 0.008 | |
| Board composed by 5 directors? | -0.016 | 0.024 | -0.663 | 50.9% | -0.065 | 0.032 | -0.065 | 0.032 | |
| % outsiders > % insiders | 0.056 | 0.044 | 1.267 | 20.8% | -0.031 | 0.143 | -0.031 | 0.143 | |
| CEO = Chairman | 0.005 | 0.020 | 0.273 | 78.5% | -0.034 | 0.045 | -0.034 | 0.045 | |
| Contingent Compensation CEO | -0.015 | 0.018 | -0.830 | 40.8% | -0.051 | 0.021 | -0.051 | 0.021 | |
| Institutional Investors | -0.115 | 0.062 | -1.850 | 6.7% | -0.238 | 0.008 | -0.238 | 0.008 | |
| Most represented institutional investor | -0.055 | 0.097 | -0.566 | 57.3% | -0.247 | 0.137 | -0.247 | 0.137 | |
| More than 50% concentrated in one institutional investor | 0.031 | 0.037 | 0.834 | 40.6% | -0.042 | 0.104 | -0.042 | 0.104 | |

Source: Elaborated by the author

From observing table 17, it is noticeable that the multiple R of the aggregated regression analysis is considerably low for statistics terms (28.44%), which suggests that the combination of these variables, given the selected sample, are still not sufficient to translate the reality.

Nevertheless, it is important to highlight that two variables (percentage of outside directors and percentage of institutional investors) have a p-value lower than 10%, which indicates that they are significant when explaining the financial return of the selected sample. Moreover, both of the variables have a negative coefficient with the dependent variable – financial return measured in terms of ROA – which partly corroborates the research question of this paper.

In other words, counter affirming what the literature very often portrays as being self-evident – stricter governance leads to higher performance – this paper has provided evidences to believe that the increase in the formal governance structure through outside directors in the board and ownership by institutional investor might actually led to worse performance. Although only two of the previously selected four parameters have proven to be significant and with negative coefficient with financial return, this paper can be considered a first attempt to demystify the widely accepted governance superiority paradigm, in the sense that stricter governance control and performance are not closely related.

5. CONCLUSION

This paper aimed at examining the relationship between governance structures perceived to be stricter – in respect to the level of control and monitor – and the financial return of the companies. The underlying reasoning is that not necessarily more sophisticated governance structures in regard to control will lead to higher financial return, given that some other aspects, such as collaboration and trust among the top management team and the board of directors although crucial, are still neglected (Zahra & Pearce, 1990).

Best corporate governance practices published in the primers of Brazilian Securities and Exchange Commission and the Brazilian Corporate Governance Institute promote board independence as much as possible, as a way to increase the effectiveness of its governance mechanism (Sanzovo, 2010). Therefore, this paper aimed at understanding if what the managerial literature portrays as being self-evident - stricter governance, better performance - can be observed in actual evidence. Thus, the question to be answered is: do companies with a stricter control and monitoring system perform better than others?

The method applied in this paper consisted on comparing 116 companies in respect to the their independence level between top management team and board directors—being that measured by four parameters, namely, the percentage of independent outsiders in the board, the separation of CEO and chairman, the adoption of contingent compensation and the percentage of institutional investors in the ownership structure – and their financial return measured in terms return on assets (ROA) from the latest Quarterly Earnings release of 2012.

The motivation to study this phenomenon was triggered by the following dilemma: although the board of director structure is widely perceived to be crucial to the organization, the role of board of directors is still under discussion, both in managerial

and academic arenas. Beyond some generally accepted responsibilities, such as hiring and firing CEOs and defining their level of compensation, the participation of the board in regards to strategic orientation of the firm is still under discussion.

Many researchers affirm that boards should perform beyond a rubber stamp role, in that sense that they only ratify decisions taken by the top management team (Cai, Liu, & Qian, 2002) (Zahra & Pearce, 1990) (Westphal J. D., 1999). From this perspective, some drawbacks should also be pointed out. As the board cooperates more closely with the top management team, there are risks associated with entrenchment and lacking independence to successfully monitor executives. Although the board of directors is the ultimate decision body, CEOs and top management team can find shortcuts to influence board members and push decisions that accommodate their own interests. In other words, there are a numbers of factors that can reduce board power vis-à-vis the CEO.

In conclusion, the challenge between the top management team and the board of directors is to build and maintain trust in their relationship, while also maintaining some distance so that effective monitoring can be achieved (Daily, Dalton, & Canella, 2003). Based on this logic, this paper expected to find an inverted curvilinear shape between the score of CEO relative power and financial return on assets.

From observing the sample, it was noticeable how homogenous the sample is in respect to the level of governance control, measured in terms of the CEO relative power. As it was explained, the sum of companies that have scored between 6 and 8 (as this range was considered the ideal balance in terms of collaboration and control) was 45.7%. This phenomenon created a crucial obstacle to draw major conclusions, as it is explained in the section limitations and suggestions for future research.

In respect to the analysis of each parameter, some interesting trends were observed.

The percentage of independent outsiders sends a clear message, as the vast majority of the companies – 83.6% - adopt between 21% and 46% of the outsiders. In that way, they only operate one level above the required percentage of 20%. Therefore, it is possible to affirm that given the already strict rules imposed by the category “Novo Mercado”, companies very rarely push beyond this level and are rather shaped by the regulatory system.

In respect to the existence of CEO duality, almost three quarters of the companies do not hold a situation in which the CEO also performs the role of chairman of the board. The literature proposes that CEO duality can be beneficial when the company is facing a difficult financial situation, as this sends a message to the market of who is in charge of the “ship” (Finkelstein & D’Aveni, 1994) (Chandler, 1962). However, as it was presented, given that the average return on assets performed by the cluster of companies that hold a CEO duality is 6.22%, while the overall average is 6.36%, this argumentation does not seem to apply here.

The observed trend in contingent compensation also has some theoretical background support. It was noticeable how the majority of the companies scored either the maximum or minimum points, which might refer to the fact that when engaged in this type of practice, companies are also seeking for legitimacy, and not only focusing on technical improvements (Zucker, 1977).

Finally, the percentage of institutional investor in the ownership breakdown showed that the sample average was 61%, while the maximum allowed by “Novo Mercado” rules is 75%.

Presented the overall trends, two regression analyses were conducted. Firstly, the correlation between each parameter and the financial return measured in terms of ROA was 10.26%, which provided initial evidence that the four selected parameters do not closely explain financial return. The second regression analysis conducted measured

the correlation between the total CEO relative power score and the financial return measured in terms of ROA. The multiple R of 5.45% indicated that less than 10% of the ROA is explained by this scale.

Aiming at deeper exploring the data, the scale was transformed into a range of dummy and continuous variables, using the Novo Mercado rules as ground framework to establish the questions to assess the companies. In that sense, a second part of the analysis was conducted.

The first regression analysis was drawn from 13 variables, being those ten dummy variables and three continuous variables. From this regression analysis, it was obtained a multiple R of 35.5%, which is still considerably low in statistics terms. Nevertheless, differently than the results obtained in the regression analysis with the CEO relative power scale, already two independent variables presented themselves as being significant, with a p-value lower than 10%.

Finally, table 17 presents the ultimate result from this paper. Excluded some variables from the previous regression analysis, given the problem of multicollinearity, the final multiple R obtained is still statistically low, 28.44%, which implies that the combination of the variables are still not enough to translate the complex reality of organizations. As mentioned earlier, some extremely important aspects of governance structures, such as selection of new CEO (Westphal J. D., 1999); CEO tenure and directors tenure (Zahra & Pearce, 1990); demographic distance (Westphal & Bednar, 2005); and amount and frequency of committee were not included in the analysis, which might the reason to low multiple R.

Nonetheless, an important finding can be taken from this paper: two variables (percentage of outside directors and percentage of institutional investor ownership) are significant in the regression, with p-value lower than 10%. In other words, counter affirming what the literature very often portrays as being self-evident – stricter

governance leads to higher performance – this paper has provided evidences to believe that the increase in the formal governance structure through outside directors in the board and ownership by institutional investor might actually lead to worse performance. Although only two of the previously selected four parameters have proven to be significant and with negative coefficient with financial return, this paper can be considered a first attempt to demystify the widely accepted governance superiority paradigm, in the sense that stricter governance control and performance do not follow the behavior exhaustively described in the literature.

6. LIMITATIONS AND FUTURE RESEARCH

As explained in the methodology section, there are three listing levels according to BM&FBovespa, to which publicly traded companies can voluntarily choose to adhere. Level 1 requires additional stock liquidity and disclosure practices. Level 2 calls for additional shareholders' rights and a board of directors. Lastly, Novo Mercado requires all the previous listed obligations, plus the compulsion of only issuing common shares (BM&F, 2011).

It is important to highlight the decision about the sample, as it was not chosen randomly. The selection of only companies comprised in the level "Novo Mercado" was due to their characteristics of adopting sophisticated governance practices. However, what seemed to be the correct decision – as the main topic of this paper is corporate governance – came with a major limitation to draw conclusive statements. In other words, exactly because companies adopted a high level of governance level – following the "Novo Mercado" requirements – they all scored extremely similar in respect to the CEO relative power score. Therefore, given the natural differences in return on assets among companies, it became inconclusive whether the governance structure – measured according to four parameters – leads to higher financial return.

Therefore, as the main limitation of this paper is the selected sample, future researches could enlarge the sample and compare companies from the listing categories Level 1 and Level 2. In that sense, governance practices could be more effectively compared and then correlated with return on assets.

Researchers have approached the topic of governance communication, which refers to only symbolically adopting governance practices, being them decoupled from reality (Dutton & Janet, 1991) (Westphal & Zajac, 1994). In future researches, when assessing governance practices and the CEO relative power with the board of directors, one could consider investigating deeper whether the announced practices are fully implemented.

In that way, more veracity is added to the inquiry, eliminating what has been labeled as institutionalization of governance, which refers to the situation wherein companies announce adoption of certain practices seeking for legitimacy from markets, investors and regulatory bodies (Zucker, 1977).

In addition, this topic could be approached from the collaborative aspect. As explained in the introduction, time constrain pushed the paper to be based on secondary data available in websites and annual reports, focusing in the control aspect of corporate governance. As Westphal (1999) have suggested, the vast majority of papers related to governance are not grounded on primary data collected from the protagonists of this complex relationship – namely directors and CEOs – but rather on public information that neglects the dynamics of relationship. Therefore, it would be extremely interesting to approach this issue of collaboration and control from the other perspective, aiming at understanding how the latter is built and whether this element affects financial return.

Finally, a limitation of this paper lies in the selected financial return to assess companies 'performance, return on assets (ROA). Although widely accepted as a short term financial measurement (Finkelstein & D'Aveni, 1994) (Westphal J. D., 1999) (Westphal & Zajac, 1994), this dimension is not completely able to grasp the real value created for the shareholders. Given that the field of corporate governance has been ultimately created as an attempt to protect shareholders' interests, it would be favorable to add a financial measure that captures the value created for the latter. In that sense, a market-based performance measure could be total returns, referring to the sum capital gain plus dividends accrued in a specific time period, divided by the share price (Westphal & Zajac, 1994).

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