Another Look at Director Independence

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Abstract

Despite the widely held view that director independence improves corporate governance, few studies find that board composition affects firm performance or CEO compensation. In this study we compare the effect of two different measures of board composition on firm performance and excessive CEO pay. We use both the traditional definition of independent outside director and a second, more behavioral, definition that excludes problem directors (directors who in prior years were on the boards of companies that failed, involved in scandals or awarded CEOs with excessive pay packages), as a rough measure of outside director quality. For a sample of 666 non-financial firms within the Russell 1000 index in 2004, we find a significant positive relationship between the percentage of non-problem outside directors and firm performance, and a significant negative effect on excess CEO compensation. Our results suggest that director quality matters more than distinguishing outside directors as being affiliated or independent.