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**Putting Their Money Where Their Mouth Is:
The Importance of Shareholder Directors
Post Listing**

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Abstract

While Luoma and Goodstein (1999) find increased stakeholder representation on the boards of American companies, Dimovski and Brooks (2004) provide evidence that the Australian initial public offering (IPO) market does not require non equity stakeholder representation on their boards. This paper analyses the change in composition of the boards of large Australian companies post listing. We find a substantial increase in the number of directors holding equity capital in the firms in which they hold their directorships. We also find a decrease in the number of non equity stakeholder directors post listing. This suggests that directors putting their money into the firms in which they have a stewardship function is an important element in the Australian capital market.

1. Introduction

In recent years there has been considerable discussion in the management literature on the accountability of companies. While the traditional finance theory focused on corporate accountability to shareholders, some management theory has argued for accountability to a wider set of interest groups. By recognition of the wider variety of stakeholders, such as employees, suppliers, customers and public representatives, that are associated with their organizations it is claimed that companies will produce better performance against a range of indicators. Agle, Mitchell and Sonnenfeld (1999) argue that understanding the needs and expectations of a broader range of stakeholders than the traditional equity shareholders is useful to profit seeking organisations. As companies recognise a wider range of stakeholders and increase their aspirations for better corporate governance, the question arises as to how companies can more appropriately safeguard the interests of non equity stakeholders. Evan and Freeman (1993), Freeman and Evan (1990) and Jones and Goldberg (1982) suggest direct stakeholder representation on the board.

If direct stakeholder representation on corporate boards is indeed useful, then as Luoma and Goodstein (1999) suggest, there is likely to be an increased representation. Companies can simply add new stakeholder directors to their boards or replace retiring directors with stakeholder directors. In their study of 224 NYSE companies over the period 1984 to 1994 they find increased stakeholder board representation.

Dimovski and Brooks (2004) investigate 270 new issues in Australia over the period 1994 to 1997 to determine the level of non equity stakeholder representation on the boards of initial public offerings (IPOs). While suppliers, suppliers with options to purchase shares, employees and employees with options to purchase shares were well represented on the boards of these IPOs, there were only 5 of 1393 non financially interested public stakeholder directors. They conclude that the IPO market in Australia does not require non equity stakeholder representation on the board.

The purpose of this paper is to examine any possible changes to the board composition of these Australian companies as they mature post listing. We investigate if the Luoma and Goodstein (1999) findings apply in the Australian context. Our investigation is of the board composition of 54 of the 270 new issues companies during 1994 to 1997 that hold a position in the top 500 companies listed on the Australian Stock Exchange in 2002.

The plan of this paper is as follows. Section 2 briefly summarises the stakeholder literature. In section 3 we report our empirical findings. Section 4 contains some concluding comments.

2. Some Previous Stakeholder Research and Hypotheses

One of the earliest contributors to the stakeholder literature was Freeman (1984) who argued that corporations should consider widening the domain of corporate governance to include non shareholder stakeholders that are associated with an organization. He suggested that understanding stakeholder needs and expectations would be important to business organisations because they may directly influence the types of strategies (and hence financial performance) of those organisations. Initially Freeman (1984) discussed three categories of stakeholders to which firms are accountable. The first was the equity stakeholder, or shareholder. The second was the economic stakeholder which included customers, suppliers, debt providers and employees. The third was the “influencer” stakeholder, which included, governments, trade associations and consumer organizations. Other classifications of stakeholders have followed.

Clarkson (1995) suggested stakeholders could be classified as primary and secondary stakeholders. Primary stakeholders include shareholders, investors, employees, customers, suppliers, government and communities (those the company depends on for its survival). The secondary stakeholders are those the company doesn't depend on for its survival.

Luoma and Goodstein (1999) presented a third classification of stakeholders. They suggested *non shareholder* stakeholders could be primary and public stakeholders. Primary stakeholders are those the company has a business relationship with, such as customers, suppliers and financiers. Public stakeholders are those the company doesn't have a business relationship with but would be interested in the activities of the organization, such as government officers, academics and community representatives.

Evan and Freeman (1993), Freeman and Evan (1990) and Jones and Goldberg (1982) have all suggested that the presence of non shareholder stakeholders at board level was important. The basis for this view is that by having a wider variety of stakeholders that the board will make decisions that better consider the needs of all groups, and not just focus on a single group. Luoma and Goodstein (1999) studied the composition of boards in the U.S. to see if board seats were actually filled by non shareholder stakeholders. They found that the proportion of private stakeholder directors (customers, suppliers, financiers) to total directors remained at 5% in each of the years 1984, 1989 and 1994. They found, however, the proportion of public stakeholder directors (government officials, academics and community representatives) to total directors was 9%, 10% and 11% in each of those years. They found that this represented a statistically significant growth in the number of non shareholder public stakeholder directors.

This study investigates the board composition of large Australian companies at the time of the initial public offering (IPO) and subsequently as these companies mature into established public companies. It also specifically investigates industry influences and organizational size influences on the board composition at the time of the IPO and subsequently. Three hypotheses are formally advanced and tested with regard to changes in the proportion of shareholder directors, public non shareholder directors and private non shareholder directors with the changes being measured by reference to the time of the IPO.

The pre-IPO owners of the firm must select the board of directors of the IPO firm at the time of preparing the prospectus. Jensen and Meckling (1976) discussed the public company reality that the shareholders of the company (principals) are separated from the managers (agents) controlling the activities of the company. This separation of ownership and control can allow conflicts of interest between these two parties where managers may act in their own interests rather than the best interests of the shareholders. Such conflicts can involve agency costs. Mak and Roush (2000) argued that it is in the interests of the pre-IPO owners to select a board with an ability to reduce any potential agency costs. They suggested that potential new investors may “price protect” themselves by either looking for higher underpricing or perhaps even refuse to buy the primary shares. Such price protection would provide a strong incentive to the pre-IPO owners to nominate an “appropriate” board with abilities to minimise these agency costs.

As the IPO company matures post listing into an established public company and is subject to greater external monitoring by the capital markets over the years, we might expect following Luoma and Goodstein (1999), the proportion of non shareholder directors to increase. Indeed public scrutiny, government scrutiny, media scrutiny and investor scrutiny might all suggest a higher level of non shareholder stakeholder board representation. This leads to the following hypothesis:

H1: The proportion of non shareholder directors on a company’s board increases as the company matures from IPO to an older, more established, top 500 Australian public company.

Scott (1995) argued that companies, which are highly accountable to the government, are highly regulated. Banks and financial services firms, transport companies and health and drug companies are examples of such highly regulated firms. Dimovski and Brooks (2004) also argued that there is a high level of public scrutiny over mining and oil companies. Such companies that are highly accountable to the public and to the government are likely to be more concerned about promoting and being seen to promote their corporate social responsibility. Therefore the following hypothesis is tested:

H2: The proportion of non shareholder stakeholder directors on a company’s board is greater in companies that operate in highly regulated industries.

Luoma and Goodstein (1999) argued that larger organizations, because of their size are subject to greater attention from the public, the media and the government. It is suggested that large firms need to promote and need to be seen to promote a higher degree of corporate social responsibility. This leads to the following hypothesis:

H3: The proportion of non shareholder stakeholder directors on a company’s board is greater in larger companies.

3. Empirical Findings

Australian Stock Exchange Float Reports were used to identify new listings on the Australian Stock Exchange over the period 1994 to 1997. A total of 270 companies raised equity capital from the public. Of these IPOs, 54 were listed as a top 500 company in the 2002 year (excluding 10 property and equity trust IPOs that have a management company managing the affairs of the trust). Board composition data was found in each of the prospectuses of the IPO companies and in the 2002 Annual Reports. Each director's interests (including shareholding and option interests) and director profiles (including occupation and affiliation) were noted. Alternate directors were not included. The prospectuses and annual reports were sourced from the respective *Connect 4* databases.

We identified the directors that had a shareholding interest in each company (direct or through one of their personally affiliated trusts or companies) and classified these as "shareholder directors". Using Luoma and Goodstein's (1999) classification of "private stakeholder directors" we identify the directors who were non equity holding customers, employees and suppliers. Similarly, we identify the non equity holding "public stakeholder directors" of government representatives and academics. A number of directors in our sample group were also non equity interested professional directors. These too were classified as public stakeholder directors.

In our initial analysis ordinary least squares (OLS) regression models are developed to examine the relationship between the dependent variables and the explanatory variables. The dependent variables examined are defined as follows:

PNSHADIR the proportion of directors who own shares directly or beneficially in the company [Luoma and Goodstein (1999)];

PNPRODOR the proportion of private stakeholder directors not holding an equity stake in the company [Luoma and Goodstein (1999)];

PNPUODOR the proportion of public stakeholder directors not holding an equity stake in the company [Luoma and Goodstein (1999)];

The explanatory variables examined are defined as follows:

POSTIPO A (0 or 1) variable with a value of 0 if the data on directors is taken at the time of the IPO or 1 if the director data is taken in 2002 [Luoma and Goodstein (1999)];

HIGHREG A (0 or 1) variable with a value of 0 if the company is less regulated and a value of 1 if the company is more heavily regulated. Heavily regulated companies are mining, oil, alcohol, transport, media, financial services, drug, medical services and gaming companies [adapted from Luoma and Goodstein (1999)];

LNMKTCAP records the natural log of the market capitalization of the company in the year of the IPO and at November 2002 [adapted from Mak and Roush (2000); Luoma and Goodstein (1999)].

Three regression models were performed with the proportion of shareholder directors

(PNSHADIR), the proportion of private stakeholder directors (PNPRODOR) and the proportion of public stakeholder directors (PNPUODOR) as the dependent variables. These models used the number of shareholder directors, private non shareholder directors and public non shareholders directors respectively in the numerator and board size in the denominator.

$$\text{PNSHADIR or PNPRODOR or PNPUODOR} = \beta_0 + \beta_1 \text{POSTIPO} + \beta_2 \text{HIGHREG} + \beta_3 \text{LNMKTCAP} + \varepsilon \quad (1)$$

where all the variables are as defined previously and the β 's are unknown parameters to be estimated.

The models test whether the proportions of shareholder directors, private stakeholder directors and public stakeholder directors changes after the initial public offering and whether they are explained by the regulatory environment in which the firm operates and by the firm's size (value) in terms of market capitalization.

An issue is whether the linear model is appropriate in this context. Because the dependent variable is a proportion of directors it is bound between 0 and 1. Thus the linear model may be inappropriate as it can produce predicted values of the proportions outside of this range. As such it is worthwhile to consider modeling in a framework that does not allow predictions outside of the bounds. One such framework is to utilize the logistic transformation in the modelling. The logistic transformation would adjust the proportions variables as follows:

$$y = \ln(p / (1-p))$$

Unfortunately this transformation is not appropriate in this context due to the boundary problems. Because we have a number of observations where the proportions are zero or one the above logistic function is not defined¹.

Table 1 reports some descriptive statistics. The mean number of board members of the IPO companies at the time of the IPO was slightly under 6 and nearly 6.5 and in 2002. The mean number of shareholder directors, private non shareholder directors and public non shareholder directors at IPO time was 2.44, 1.17 and 2.30 respectively. The mean number of shareholder directors, private non shareholder directors and public non shareholder directors in 2002 was 5.76, 0.06 and 0.63 respectively. The mean proportion of shareholder directors, private non shareholder directors and public non shareholder directors at IPO time was 0.48, 0.19 and 0.33 respectively. The mean proportion of shareholder directors, private non shareholder directors and public non shareholder directors in 2002 was 0.89, 0.01 and 0.10 respectively.

Table 1
Descriptive Statistics for Dependent Variables

	IPO			Top 500 Company in 2002		
	mean	median	(n=54) s.d.	mean	median	s.d.
Board Size	5.91	5	2.03	6.44	6	1.83
No. of shareholder directors	2.44	2	2.00	5.76	5	1.99
No. of private stakeholder directors	1.17	1	1.68	0.06	0	0.30
No. of public stakeholder directors	2.30	1	3.08	0.63	0	1.07
Proportion of shareholder directors	0.48	0.50	0.38	0.89	1	0.16
Proportion of private stakeholder directors	0.19	0.11	0.26	0.01	0	0.04
Proportion of public stakeholder directors	0.33	0.25	0.34	0.10	0	0.15

¹ A further option would be to utilize a double censored tobit model in the empirical analysis. This would involve replacing the boundary points (0 or 1) with a number very close to the boundary. This number is arbitrary so computationally intensive sensitivity analysis is needed. Because of the computational intensity we do not pursue this option in this paper.

Table 2
OLS of Proportion of Shareholder, Private and Public Stakeholder
Directors and Explanatory Variables *

Variable	PNSHADIR		PNPRODIR		PNPUODIR	
	Coefficient	Pr.	Coefficient	Pr.	Coefficient	Pr.
C	0.631	0.000	0.225	0.000	0.144	0.066
POSTIPO	0.452	0.000	-0.180	0.000	-0.272	0.000
HIGHREG	0.056	0.302	-0.004	0.916	-0.052	0.273
LNMKTCAP	-0.040	0.019	-0.007	0.412	0.047	0.008
J-B	0.990	0.610	295.774	0.000	6.656	0.036
White	21.820	0.000	11.322	0.023	22.421	0.000
Reset	3.829	0.000	4.641	0.545	6.283	0.000
Adj R-squared	0.364		0.181		0.222	

* White (1980) heteroscedasticity-consistent coefficients and p-values are reported.

These are interesting descriptive results: briefly, of our sample 54 IPOs that rank in Australia's top 500 publicly listed companies in 2002, nearly 5 in 10 directors are shareholder directors at IPO time but nearly 9 in 10 directors are shareholder directors in 2002.

The descriptive statistics identify that on average there are 41% more shareholder directors in our 2002 companies than when those companies floated. This has come about by the sample companies exchanging 18% of their private stakeholder directors and 23% of their public stakeholder directors at IPO time for greater proportion of shareholder directors by 2002.

Table 2 reports the results of the OLS regressions with the proportion of shareholder directors, proportion of private stakeholder directors and proportion of public stakeholder directors as the dependent variables. The results reveal the following patterns. Hypothesis 1 is supported by the significantly positive coefficient on the POSTIPO variable in the shareholder directors regression and by the significantly negative coefficient on the POSTIPO variable in the private and public stakeholder directors regression. Hypothesis 2 is not supported as the HIGHREG variable is insignificant in all three regressions. Hypothesis 3 is supported by the significantly positive coefficient on the market capitalisation variable in the public stakeholder directors regression.

To evaluate the reliability of the estimated models a range of standard regression diagnostics are reported. As a measure of goodness of fit we report the adjusted R². These values range from 18% to 36%. As a test for normality the Jarque-Bera (J-B) test is reported. These results indicate some non-normality issues in the stakeholder directors regressions. Given the reported p-values on the coefficients this is not likely to be a problem for inference. As specification tests both Reset and White tests are reported. These indicate some heteroscedasticity problems. To adjust for this White (1980) adjusted p-values and coefficients are reported.

4. Conclusion

We find a substantial increase in the number and in the proportion of shareholder directors to non shareholder directors. It appears that not quite 5 in 10 IPO company directors are shareholder directors while nearly 9 of every 10 directors have a shareholding interest by 2002. The coefficients on the explanatory variable POSTIPO, as they relate to shareholder directors (positive) and private and public stakeholder directors (negative) are highly significant. This suggests the importance of directors essentially putting their money where their mouth is, is an important element in the Australian capital market. This growth in shareholder directors compared to stakeholder directors is somewhat contrary to Luoma and Goodstein's (1999) finding, although this study monitors the change in directors post IPO while Luoma and Goodstein's (1999) study monitors the change in directors of existing listed companies. Perhaps the Australian capital market deals with Jensen and Meckling's (1976) agency cost problem by seeking directors with a shareholding interest. Such directors have a self interested incentive to work in the best interests of shareholders because they themselves are shareholders. We also find, however, that larger companies are likely to employ a higher proportion of public stakeholder directors.

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