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**Independent Director Incentives**  
Where do talented directors spend their time  
and energy?

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Corporate Governance  
(Empirical)

# Boards Are a Critical Governance Mechanism

- They have power to approve all major corporate decisions and hire, fire and compensation senior management
- A primary research question is: What affects the functioning of boards?
- Most research focuses on whether directors are independent
- But what are the incentives of independent directors (IDs) to perform?
- One major incentive is **director reputation** – which is clearly affected by a director's prior performance
- When IDs are highly sought after, they are often on multiple boards – does this reflect their **talent** or make them **too busy** to be effective?
- **Key question:** Is director performance on all their boards equally important or do directors prioritize their time and energy to their more prestigious boards?

# Director Reputation Incentives: Prior Studies

## o Theories – Reputation matters

- o Reputation is a valuable asset - Alchian and Demsetz (1972)
- o Directors want to be viewed externally as valuable monitors to increase the value of their human capital- Fama (1980) and Fama and Jensen (1983)

## o Evidence on Independent Director (ID) Reputation?

- o No studies on the direct effects of reputation
- o Yet many empirical studies **assume director reputation matters!**
  - o CEO performance, Brickley, Coles and Linck (1999);
  - o Forced CEO departures, Farrell and Whidbee (2000);
  - o Firm stock performance, Yermack (2004);
  - o Firm dividend reductions, Kaplan and Reishsus (1990);
  - o Bankruptcy filings, Gilson (1990);
  - o Financial fraud, Fich and Shivdasani (2007);
  - o Earnings restatements, Srinivasan (2005);
  - o Option back-dating, Ertimur, Ferri and Maber (2011)

# IDs with Multiple Directorships: Prior Studies

## o **Talented (Strengthen Boards)**

- o Kaplan and Reishsus (1990), Gilson (1990), Shivdasani (1993), Shivdasani and Yermack (1999), Chidambaran, Kedia and Prabhala (2011), Masulis and Mobbs (2011) and Mobbs (2012)

## o **Too Busy (Weaken Boards)**

- o Ferris, Jagannathan and Pritchard (2003), Fich and Shivdasani (2006), Core, Holthausen and Larcker (1999), Beasley (1996) and Field, Lowry and Mkrtchyan (2011)

- o This literature **assumes directors distribute their effort uniformly**, but this is never directly tested.

## o **Maybe the same director can be good for some firms & bad for others**

- o We investigate potential heterogeneous reputation incentives of an individual director across his/her multiple directorships

# Director Preferences – Supply Side Effects

## Independent directors...

- Do not like to be associated with poorly performing firms
  - Fahlenbrach, Low and Stulz JFE (2010)
- Prefer to serve on local boards, but have a greater willingness to travel to serve on the boards of larger firms
  - Knyazeva, Knyazeva and Masulis RFS(2013)

## IDs with multiple directorships may...

- Not view all their directorships as equally important
- Devote more of their limited time and energy to directorships at *relatively* more prestigious firms
- More often retain their more prestigious directorships

# ID Reputation Incentives Vary

- o Larger more visible firms provide a stronger signal of director talent and value - Fama (1980)
- o Firm size is a natural measure of director reputation incentives - Adams and Ferreira (2008) and Fich and Shivdasani (2007)
  - o It's correlated with visibility and prestige - Shivdasani (1993)
  - o It's correlated with the likelihood of obtaining additional directorships - Yermack (2004) and Fich (2005)
- o Thus, a director's reputation incentives are predicted to vary across directorships as a function of firm size
- o We measure firm size by equity capitalization

# Sample

- o Risk Metrics director data from 1997 – 2006 period
- o Director data for S&P1500 firms each year
  - o 131,325 director-year observations
  - o 86,330 ID-years
  - o **45,606 ID-years with multiple directorships** (Mean 2.41 directorships)
- o Firm level measures
  - o 15,215 firm-year observations (12,166 excluding finance and utilities)
  - o **Percentage of independent directors** who view this as one of their **higher ranked** (lower ranked) directorships is 13% (14%)
  - o **Indicator for when a majority of independent directors** view this as a **higher ranked** (lower ranked) directorship is 15% (15%)

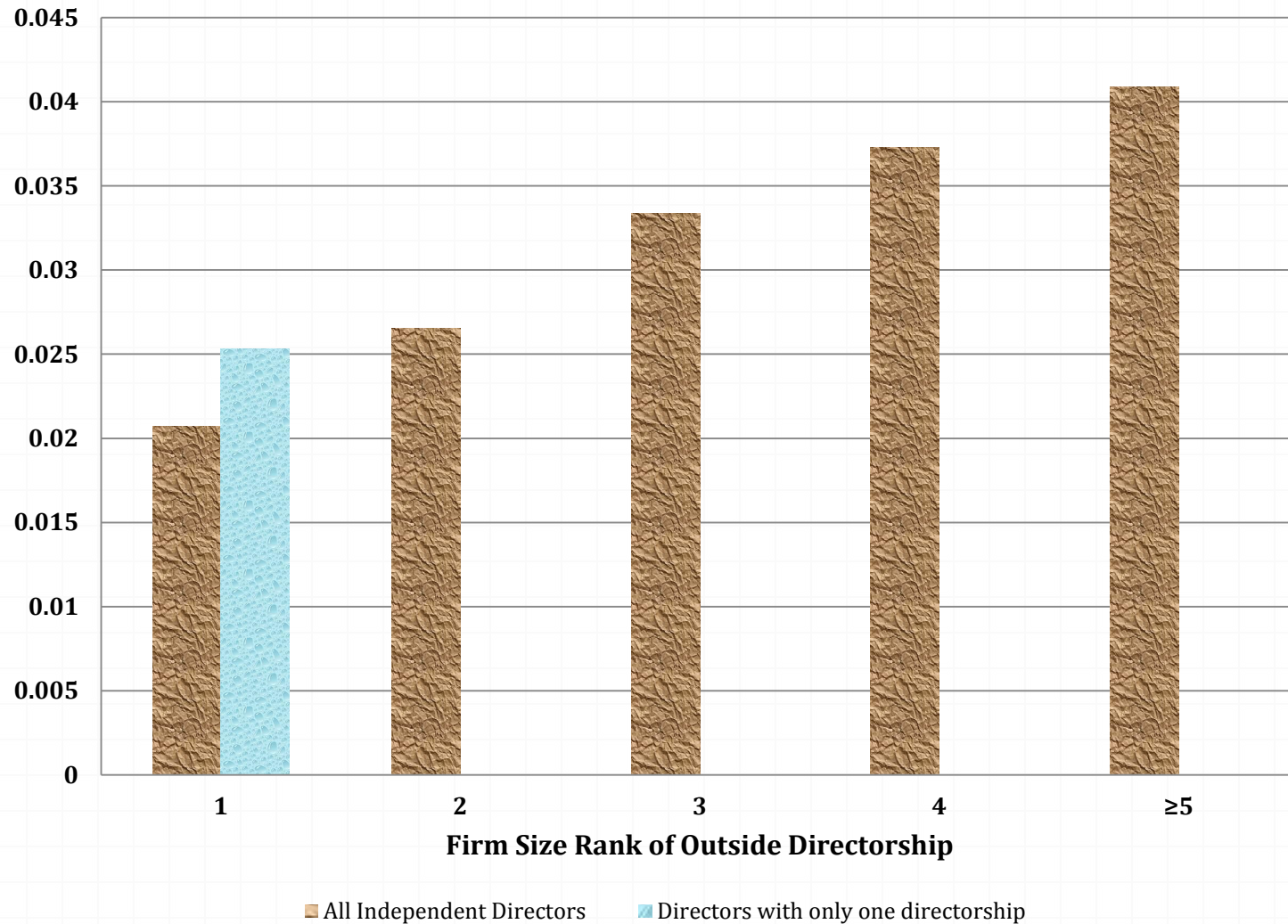


# Director Level Analysis (Annual)

- Rank directorships of individual directors (by a firm's equity capitalization)
  - Identify lower and higher ranked directorships of an individual director
  - Higher (Lower) ranked directorships - at least 10% larger (smaller) in stature than their lowest (highest) stature directorship
- Director willingness to put forth effort is measured by
  - Board meeting attendance (indicator of director missing over 25% of meetings)
- H1: *Directors will be more active on the boards of their relatively more prestigious firms.*



# Figure 1. Board Meeting Absences



# Methodology for Board Meeting Absences

- Individual director-firm analysis
- Probit Regressions on directors who miss over 25% of board meetings
- Key Control Variables: ID rankings of a board (ID%Hi, ID%Low, IDs>50%Hi, IDs>50%Low)
- Other control variables: Number of meetings, director characteristics (share ownership, age), board characteristics (size, tenure, annual retainer, meeting fee), post-SOX indicator and firm characteristics
- **Key findings: Directors in**
  - **higher ranked & sole directorships** have significantly **fewer absences**
  - **lower ranked directorships** have significantly **more absences**
- **Next Test:** Difference-in-difference analysis of change in director rankings due to an exogenous shock (change in size of another firm)
- **Key control:** interaction of post-treatment period & treatment director
- **Note:** treatment is a rise in the firm's ranking by treated director

# Board Meeting Absences

## Panel D: Multivariate

**Dependent variable:**  
**Attended <75% of Meetings**

	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
	Probit (1/0)	Probit (1/0)	Probit (1/0)	Probit (1/0)	Probit (1/0)	Probit (1/0)
High Ranked Directorship	-0.078** (0.01)	-0.099*** ( $<.01$ )	-0.101*** ( $<.01$ )	-0.075** (0.02)	-0.082*** (0.01)	-0.085*** ( $<.01$ )
Low Ranked Directorship	0.085*** ( $<.01$ )	0.065** (0.04)	0.0630** (0.05)	0.088*** ( $<.01$ )	0.081*** ( $<.01$ )	0.075** (0.02)
Sole Directorship	-0.103*** ( $<.01$ )	-0.079** (0.03)		-0.11*** ( $<.01$ )	-0.11*** ( $<.01$ )	-0.12*** ( $<.01$ )
Number of outside directorships		0.023 (0.12)	0.028* (0.06)			
Major Committee Membership				-0.161*** ( $<.01$ )	-0.144*** ( $<.01$ )	-0.137*** ( $<.01$ )
Annual Director Retainer					-0.001 (0.69)	-0.001 (0.65)
Director Meeting Fee					-0.002** (0.02)	-0.002** (0.03)
Number of Board Meetings						-0.063*** ( $<.01$ )
Board Tenure	-0.002 (0.26)	-0.002 (0.24)	-0.0004 (0.41)	-0.001 (0.56)	-0.06*** ( $<.01$ )	-0.016*** ( $<.01$ )
Board Size	0.04*** ( $<.01$ )	0.04*** ( $<.01$ )	0.045*** ( $<.01$ )	0.037*** ( $<.01$ )	0.035*** ( $<.01$ )	0.035*** ( $<.01$ )
Ln(Director Age)	-0.329*** ( $<.01$ )	-0.338*** ( $<.01$ )	-0.606*** ( $<.01$ )	-0.318*** ( $<.01$ )	-0.341*** ( $<.01$ )	-0.342*** ( $<.01$ )
Director Ownership	0.001 (0.89)	0.001 (0.9)	-0.0004 (0.96)	-0.001 (0.87)	0.0009 (0.9)	0.0015 (0.83)
Post-SOX	-0.263*** ( $<.01$ )	-0.26*** ( $<.01$ )	-0.336*** ( $<.01$ )	-0.259*** ( $<.01$ )	-0.23*** ( $<.01$ )	-0.231*** ( $<.01$ )
Ln(Market Cap)	-0.047*** ( $<.01$ )	-0.048*** ( $<.01$ )	-0.061*** ( $<.01$ )	-0.045*** ( $<.01$ )	-0.031*** ( $<.01$ )	-0.029** (0.01)
ROA	-0.017 (0.54)	-0.016 (0.58)	-0.005 (0.9)	-0.016 (0.57)	0.022 (0.63)	0.001 (0.98)
Q	0.011** (0.01)	0.011** (0.01)	0.011** (0.03)	0.011** (0.01)	0.004 (0.48)	0.004 (0.47)
Number of Observations	84676	84676	44717	84676	80118	78538
Pseudo-R <sup>2</sup>	3.25%	3.27%	4.33%	3.42%	3.25%	3.40%

## Firm A



## Firm B



**T=0: Purple** Director: Ranks **A** as 2

**Purple** Director: Ranks **B** as 1

Later **Firm B** decreases in size - resulting in a new ranking by Purple Director

**T=1: Purple** Director: Ranks **A** as 1

**Purple** Director: Ranks **B** as 2

**Purple** Director in **Firm A** is TREATMENT director

**Red** Directors in **Firm A** are CONTROL directors

# Exogenous Changes in Directorship Rank: Difference-in-Difference Analysis: Board Absences

<i>Director Level Meeting Absences</i>	Model 1	Model 2	Model 3	Model 4	Model 5
<i>Dependent variable:</i>	Probit	Probit	Probit	Probit	Probit
<i>Attended &lt;75% of Meetings</i>	(1/0)	(1/0)	(1/0)	(1/0)	(1/0)
Treatment Director	0.187 (0.28)	0.208 (0.25)	0.193 (0.3)	0.782*** (<.01)	0.958*** (<.01)
Post-Treatment Indicator	0.008 (0.93)	0.228** (0.04)	0.189 (0.13)	0.159 (0.39)	0.368* (0.1)
Post-Treatment X Treatment Director	-0.37* (0.07)	-0.473** (0.02)	-0.496** (0.02)	-0.723** (0.03)	-0.827** (0.01)
Number of Observations	6157	5701	3753	1711	1079
Controls	No	Yes	Yes	No	Yes
Pseudo-R <sup>2</sup>	0.29%	6.85%	8.72%	2.52%	13.06%

**Treatment directors** are independent directors with multiple directorships for whom the firm of one of their directorships decreased in size and therefore resulted in a rank decrease for that directorship and a corresponding rank increase for the director's other directorships.

**Control directors** are the remaining independent directors on the board of the treatment director firm.

# Director Level Analysis (cont.)

- Decisions to leave or remain on boards: Directors at firms with poor performance face higher workloads & fewer reputation benefits – so they are more likely to resign
- Approach:
  - Measure director departure frequency
  - H2a: *Directors are more likely to give up their less prestigious directorships than their more prestigious directorships.*
  - Measure director departure sensitivity to firm performance
  - H2b: *Directors strive to retain more prestigious directorships, even under adverse conditions. **Director departures** from **higher ranked** (lower ranked) boards are **less** (more) **sensitive** to **poor firm performance***
  - **Probit regressions** of likelihood of resigning from directorship
  - **Key explanatory variables:** Director's ranking of board & the interaction with lagged firm performance measures

# Directorships Relinquished: Sensitivity to Firm Performance

<i>Panel B: Multivariate</i>		Model 1	Model 2	Model 3	Model 4
<i>Dependent variable: Directorship lost<sub>(t+1)</sub></i>		Probit (1/0)	Probit (1/0)	Probit (1/0)	Probit (1/0)
High Ranked Directorship		0.451*** ( <i>&lt;.01</i> )	0.221*** ( <i>&lt;.01</i> )	0.483*** ( <i>&lt;.01</i> )	0.234*** ( <i>&lt;.01</i> )
Low Ranked Directorship		0.63*** ( <i>&lt;.01</i> )	0.318*** ( <i>&lt;.01</i> )	0.663*** ( <i>&lt;.01</i> )	0.351*** ( <i>&lt;.010</i> )
Annual Return		-0.108*** ( <i>&lt;.01</i> )	-0.106*** ( <i>&lt;.01</i> )		
High Ranked Directorship x Annual Return		0.127*** ( <i>&lt;.01</i> )	0.083** ( <i>0.02</i> )		
Low Ranked Directorship x Annual Return		-0.174*** ( <i>&lt;.01</i> )	-0.147*** ( <i>&lt;.01</i> )		
ROA				-0.003 ( <i>0.98</i> )	0.018 ( <i>0.89</i> )
High Ranked Directorship x ROA				-0.165 ( <i>0.25</i> )	-0.208 ( <i>0.15</i> )
Low Ranked Directorship x ROA				-0.349** ( <i>0.02</i> )	-0.333** ( <i>0.02</i> )

Significantly different

\*Note: Only considers directors with multiple directorships.  
Other controls: Firm size, Board tenure, Director Ownership, Director Age, Number of directorships, CEO age, Percent Independent Directors



# Firm Level Analysis

- o Our measures of IDs with multiple directorships capture 2 important director characteristics
  - (1) These IDs have greater talent & experience
  - (2) These IDs have greater incentives to perform well in their higher ranked directorships
- o **Board level** independent director (ID) reputation incentives (4):
  - o % IDs rank board high (low)
  - o Indicator for a majority of IDs rank the board high (or low)
- o Examine firm performance & value - conditional on ID rankings
  - o H3: *Firms with more IDs who view this as a relatively more prestigious directorship are associated with*
    - (a) *better operating performance (ROA)*
    - (b) *higher Tobin's Q values*

# ID Rankings and Firm Performance & Value

<i>Panel D : Multivariate</i>	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8
<i>Dependent Variable:</i>				Ind. Adj.				Ind. Adj.
	ROA	ROA	ROA	ROA	Ln(Q)	Ln(Q)	Ln(Q)	Ln(Q)
Percent Independent High Ranked	0.0019*** ( <i>&lt;.01</i> )				0.009*** ( <i>&lt;.01</i> )			
Percent Independent Low Ranked	-0.001*** ( <i>&lt;.01</i> )				-0.0046*** ( <i>&lt;.01</i> )			
Majority of Independent High		0.048*** ( <i>&lt;.01</i> )	0.025*** ( <i>&lt;.01</i> )	0.022*** ( <i>&lt;.01</i> )		0.252*** ( <i>&lt;.01</i> )	0.131*** ( <i>&lt;.01</i> )	0.109*** ( <i>&lt;.01</i> )
Majority of Independent Low		-0.035*** ( <i>&lt;.01</i> )	-0.0240*** ( <i>&lt;.01</i> )	-0.023*** ( <i>&lt;.01</i> )		-0.123*** ( <i>&lt;.01</i> )	-0.096*** ( <i>&lt;.01</i> )	-0.083*** ( <i>&lt;.01</i> )
Majority of Independent (Only)				-0.004 (0.23)				-0.008 (0.47)
Majority Independent	0.00091 (0.86)	0.002 (0.74)	0.002 (0.64)		-0.008 (0.65)	0.012 (0.480)	-0.003 (0.850)	
Busy Board				-0.007* (0.09)				0.013 (0.29)
Fixed Effect	Industry	Industry	Firm	Firm	Industry	Industry	Firm	Firm
Number of Observations	10566	10566	10566	10566	10363	10363	10363	10363
Adjusted-R <sup>2</sup>	16.02%	14.21%	77.94%	78.21%	46.53%	43.91%	80.38%	76.31%

Other controls: Outside Director Ownership, CEO Ownership, Founder Presence, R&D/Assets, Depreciation/Sales, Firm size, Firm age, Business Segments, Stock Volatility and Year Fixed Effects. Sample Excludes financials and utilities.

# Exogenous Changes in Board Ranking by a Director: Difference-in-Difference Analysis of Firm Performance & Value

<i>Firm Level Performance and Value</i>	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
<i>Dependent variable:</i>	Ind. Adj. ROA	Ind. Adj. ROA	Ind. Adj. Ln(Q)	Ind. Adj. Ln(Q)	Ind. Adj. ROA	Ind. Adj. Ln(Q)
Treatment Director	-0.007 (0.38)	-0.005 (0.52)	-0.089** (0.01)	-0.083*** ( $<.01$ )	-0.022*** ( $<.01$ )	-0.087*** ( $<.01$ )
Post-Treatment Indicator	-0.014** (0.03)	-0.015* (0.07)	-0.067*** ( $<.01$ )	-0.045 (0.12)	-0.011 (0.14)	-0.018 (0.45)
Post-Treatment X Treatment Director	0.017** (0.04)	0.011 (0.23)	0.089*** ( $<.01$ )	0.066** (0.04)	0.022*** ( $<.01$ )	0.048* (0.09)
Number of Observations	1935	1686	1938	1664	2330	2301
Controls	No	Yes	No	Yes	Yes	Yes
Adjusted-R <sup>2</sup>	2.39%	11.02%	4.07%	36.27%	10.31%	31.31%

**Treatment firms** are those with at least one treatment director from the director level analysis.

**Control firms** are those closest in size to the treatment firm, by market capitalization, in the same industry and without a treatment director.

# Firm Level Analysis (continued)

## o Test:

- o Examine CEO monitoring (Forced CEO Turnover to Performance)
- o H4: *Firms with **more independent directors** for whom this is a **more prestigious** directorship are associated with CEOs having **higher forced turnover sensitivity** to performance*
- o **Approach:** Probit regressions with year & industry or firm fixed effects with robust standard errors are clustered by firm
- o **Firm performance measures:** Lagged Industry Adjusted Stock Return or Industry Adjusted ROA

# Evidence on Sensitivity of Forced CEO Turnover to Performance

**Key Explanatory Variable:** Interaction of IDs rankings and firm performance measures

**Control variables:** many standard variables including board independence and busy boards

**Key Findings:** Interaction terms are **significantly negative** for **% IDs with high rankings** & **majority of IDs with high rankings** and insignificant for IDs with low rankings.

**Implication:** When industry-adjusted firm performance is negative these boards are more likely to fire the CEO!

# Summary

- Independent directors prioritize across their directorships
  - Independent directors are more active on their relatively more prestigious boards
  - Director departures are less sensitive to firm performance
- Director monitoring efforts vary with a board's relative stature
  - Firms with greater portion of independent directors who view this board as more prestigious are associated with....
    - Better firm performance & value
- Directors want to protect their most prestigious boards by
  - Building a good relationship with the CEO, provided that firm performance is not seriously declining – but if it is, these directors want to act decisively
    - Force CEO turnover overall is less likely
    - Force CEO turnover is more sensitive to performance
- In conclusion: Independent director reputation concerns are important & they appear to strongly influence the efforts they expend

# Further Tests: Firm Actions with Reputation Consequences

Situations with Close Alignment of Interests of Directors & Shareholders

## **Negative Board Outcomes:**

Exchange Initiated Delisting

Covenant Violations

Earnings Management

Earnings Restatements

Shareholder Lawsuits

Lucky CEO Option Grants

Dividend Reductions

Gilson (1990)

Srinivasan (2005)

Fich and Shivdasan (2007)

Kaplan and Reishsus (1990)

## **Positive Board Decision:**

CEO's % Equity Based Comp



# Empirical Evidence on Firm Actions and ID Reputation Incentives

IDs Ranking of Board:    ID%Hi    ID%Low    50%IDsHi    50%IDsLow

## Negative Consequences:

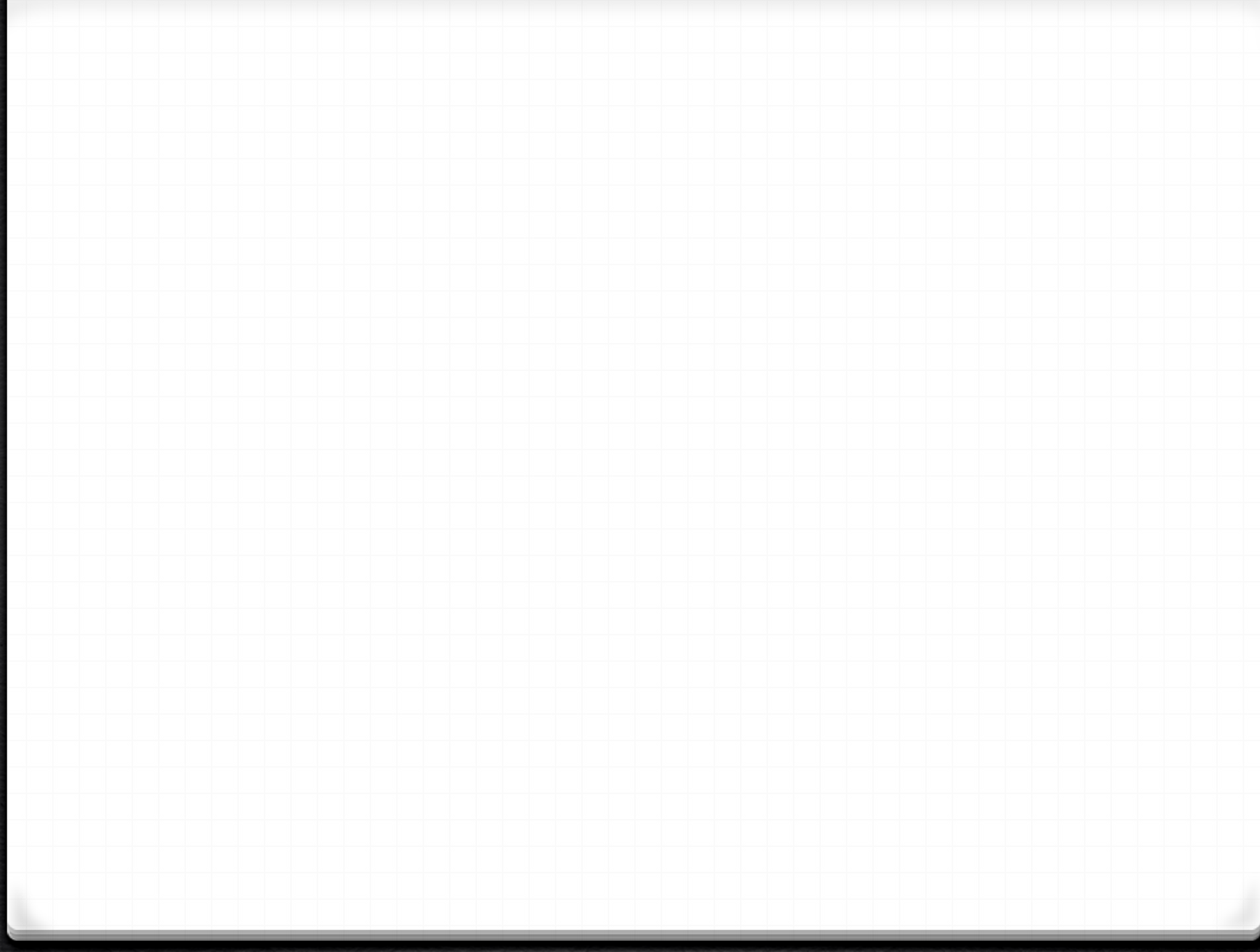
Exchange Delistings	-	+	-	
Covenant Violations	-	+	-	+
Earnings Management	-		-	
Shareholder Lawsuits	-		-	
Lucky CEO Option Grants	-		-	
Dividend Reductions	-	+		+

## Positive Consequences:

CEO % Equity Comp	+	-	+	-
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# Summary of Evidence on Firm Actions

- Firms with greater representation by directors with stronger reputation incentives are associated with lower probability of negative firm outcomes:
  - Delistings, covenant violations, earnings management & restatements, shareholder lawsuits, option backdating & dividend reductions
- Directors with greater reputation incentives want to be viewed by shareholders as reliable fiduciary agents
  - Support more sensitive CEO compensation to firm performance
- Directors with greater reputation incentives are motivated to support actions which enhance board prestige & protect their most valuable directorships. In further analysis we find that they are...
  - more likely to support cautious acquisitions
  - associated with greater levels of takeover defenses
- **Directors prioritize their directorships** based on reputation incentives & these incentives significantly influence board decision making



# Forced CEO Turnover Sensitivity to: Stock Performance

<i>Panel A: Stock Performance</i>	Model 1	Model 2	Model 3	Model 4	Model 5
<i>Dependent Variable: Forced CEO Departure (1/0)</i>	Forced CEO Departure (1/0)	Forced CEO Departure (1/0)	Forced CEO Departure (1/0)	Forced CEO Departure (1/0)	Forced CEO Departure (1/0)
Percent Independent High Ranked <sub>(t-1)</sub>	-0.01** (0.05)	-0.01 (0.27)	-0.011** (0.02)		
Percent Independent Low Ranked <sub>(t-1)</sub>	0.001 (0.84)	0.001 (0.85)	0.001 (0.77)		
Majority Independent High <sub>(t-1)</sub>				-0.24 (0.47)	-0.24 (0.46)
Majority Independent Low <sub>(t-1)</sub>				0.07 (0.75)	0.08 (0.71)
Average Industry Adjusted Stock Return <sub>(t-1 to t)</sub>	-2.21*** (<.01)	-2.15*** (<.01)	-2.07*** (<.01)	-2.42*** (<.01)	-1.6*** (<.01)
Percent Independent High Ranked <sub>(t-1)</sub> X Average Industry Adjusted Stock Return <sub>(t-1 to t)</sub>	-0.032* (0.08)	-0.034*** (<.01)	-0.03** (0.03)		
Percent Independent Low Ranked <sub>(t-1)</sub> X Average Industry Adjusted Stock Return <sub>(t-1 to t)</sub>	-0.002 (0.92)	-0.001 (0.95)	-0.002 (0.91)		
Majority Independent High <sub>(t-1)</sub> X Average Industry Adjusted Stock Return <sub>(t-1 to t)</sub>				-0.65** (0.05)	-0.54* (0.06)
Majority Independent Low <sub>(t-1)</sub> X Average Industry Adjusted Stock Return <sub>(t-1 to t)</sub>				-0.222 (0.75)	-0.27 (0.71)

Other controls: Board size, High Outside director holdings, Institutional holdings, firm size, CEO board tenure, CEO of retirement age and year and industry fixed effects

# Operating Performance

**Panel B: Operating Performance**

	Model 1	Model 2	Model 3	Model 4	Model 5
<i>Dependent Variable: Forced CEO Departure (1/0)</i>	Forced CEO Departure (1/0)	Forced CEO Departure (1/0)	Forced CEO Departure (1/0)	Forced CEO Departure (1/0)	Forced CEO Departure (1/0)
Percent Independent High Ranked <sub>(t-1)</sub>	-0.01** (0.05)	-0.01** (0.03)			
Percent Independent Low Ranked <sub>(t-1)</sub>	0.001 (0.89)	0.001 (0.81)			
Majority Independent High <sub>(t-1)</sub>			-0.27 (0.14)	-0.27 (0.16)	-0.17 (0.48)
Majority Independent Low <sub>(t-1)</sub>			0.02 (0.89)	0.03 (0.85)	0.05 (0.85)
Average Industry Adjusted ROA <sub>(t-1 to t)</sub>	-2.06** (0.01)	-1.77* (0.07)	-2.63** (0.01)	-2.42*** (<.01)	-1.99** (0.05)
Percent Independent High Ranked <sub>(t-1)</sub> X Average Industry Adjusted ROA <sub>(t-1 to t)</sub>	-0.069* (0.09)	-0.07** (0.05)			
Percent Independent Low Ranked <sub>(t-1)</sub> X Average Industry Adjusted ROA <sub>(t-1 to t)</sub>	-0.017 (0.61)	-0.02 (0.65)			
Majority Independent High <sub>(t-1)</sub> X Average Industry Adjusted ROA <sub>(t-1 to t)</sub>			-2.34 (0.25)	-3.84* (0.08)	-6.08** (0.02)
Majority Independent Low <sub>(t-1)</sub> X Average Industry Adjusted ROA <sub>(t-1 to t)</sub>			-1.07 (0.22)	-1.4 (0.11)	-1.72 (0.39)
Majority Independent <sub>(t-1)</sub>			0.22 (0.13)		
Majority Independent <sub>(t-1)</sub> X Average Industry Adjusted ROA <sub>(t-1 to t)</sub>			0.35 (0.75)		
Busy Board <sub>(t-1)</sub>				0.005 (0.98)	-0.022 (0.93)
Busy Board <sub>(t-1)</sub> X Average Industry Adjusted ROA <sub>(t-1 to t)</sub>				2.91 (0.15)	5.36** (0.03)