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Investigating the effect of board independence on performance across different strategies ☆

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Abstract

This study investigates the effect of board independence on performance across different strategies. Using moderated regression analyses, the results confirm our hypothesis that board independence has a significantly more positive effect on performance for firms pursuing a strategy of cost efficiency than for those pursuing a strategy of innovation. The results of this study indicate that consideration of firms' competitive strategy can provide a better understanding of the relationship between board independence and firm performance.
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Keywords: Board independence; Competitive strategy; Performance; Corporate governance

1. Introduction

Corporate governance, a system by which firms are directed and controlled in order to ensure their continuity in business, is the responsibility of senior management and the board of directors (The UK Financial Reporting Council & The London Stock Exchange, 1991).

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[2] Both authors contributed equally to this study's development. The sequence of names was determined in random order. The data are available from public sources. A list of sample firms is available from the corresponding author upon request. This paper has benefited from comments and suggestions from Sue Haka (associate editor), the two anonymous reviewers of this journal and from participants at the Asian Academic Accounting Association Fourth Annual Conference, Bangkok, Thailand.

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Accordingly, the various reforms[3] that have been introduced in recent years to promote sound corporate governance include: requiring a majority of board members to be independent; tightening the standards for determining a member's independence; creating committees composed predominantly of outside directors with professional qualifications; reducing the number of board members in order to facilitate more effective decision making; minimizing management's control over the appointment of board and committee members; and encouraging the review of performance of the board and of each board member.

Despite the widely-held belief that sound corporate governance is the foundation of a firm's long-term success, empirical studies examining the relationship between corporate governance and performance have generated inconsistent findings. Some studies provide evidence that corporate governance has a positive effect on performance (e.g., Brickley, Coles, & Terry, 1994; Brickley & James, 1987; Byrd & Hickman, 1992; Chung, Wright, & Kedia, 2003; Hossain, Cahan, & Adams, 2000; Lee, Rosenstein, Rangan, & Davidson, 1992; Rosenstein & Wyatt, 1990; Weisbach, 1988). However, other studies, report a negative association between corporate governance and firm performance (e.g., Bathala & Rao, 1995; Hutchinson, 2002) or find that corporate governance does not have any impact on performance (e.g., Park & Shin, 2003; Prevost, Rao, & Hossain, 2002; Singh & Davidson, 2003; Young, 2003).

There are several possible explanations for these inconsistencies. First, Young (2003) argues that methodological differences may at least in part explain them, given that some studies use publicly available data to measure corporate governance variables while others use survey data. Second, it is possible that the choice of performance variables might also play a role in explaining the mixed results. Some studies use accounting-based performance measures such as Return on Assets, Return on Equity, or Asset Turnover, (e.g., Hutchinson & Gul, 2004; Park & Shin, 2003; Singh & Davidson, 2003) while others use market-based performance measures such as Stock Return or Market Value of Equities (e.g., Baysinger & Butler, 1985; Brickley et al., 1994; Cotter, Shivdasani, & Zenner, 1997; McWilliams & Sen, 1997).

Third, a recent study by Hutchinson and Gul (2004) provides evidence that good corporate governance moderates the negative relationship between a firm's opportunity for growth and its performance. Insights gleaned from this research suggest that the impact of corporate governance variables on firms' performance should be evaluated in relation to their contextual variables. It is, therefore, possible that addressing the role of contextual variables could provide an opportunity to expand our understanding of the relationship between corporate governance and firm performance.

The purpose of this study is to investigate the effect of board independence–one of the most widely used proxies for good governance–on performance across different strategies

[3] The Sarbanes-Oxley Act of 2002, Toronto Stock Exchange Corporate Governance Guidelines of 1996, Organization for Economic Co-operation and Development (OECD) Principles of Corporate Governance (1999), Nasdaq Corporate Governance Rule Proposal of 2003, are just a few examples of numerous codes of best practices proposed and adopted by national stock exchanges, professional organizations, legal practitioners, and business leaders promoting sound corporate governance.

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