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Impact of board independence on the quality of community disclosures in annual reports

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ABSTRACT

This study investigates the link between board independence and the quality of community disclosures in annual reports. Using content analysis and a panel dataset from UK FTSE 350 companies the results indicate a statistically significant relationship between board independence, as measured by the proportion of nonexecutive directors, and the quality of community disclosures, while holding constant other corporate governance and firm specific variables. The study indicates that companies with more non-executive directors are likely to disclose higher quality information on their community activities than others. This finding offers important insights to policy makers who are interested in achieving optimal board composition and furthers our understanding of the firm's interaction with its corporate and extended environment through high-quality disclosures. The originality of this paper lies in the fact that it is the first to specifically examine the relationship between outside directors and community disclosures in annual reports. The paper contributes both to the corporate governance and community disclosure literature.

1. Introduction

This study examines the impact of board composition on corporate community involvement disclosure (CCID) for a sample of UK listed companies. The composition of the board of directors in a company is crucial in providing strategic direction (Chen & Jaggi, 2000; Gul & Leung, 2004). It is therefore not surprising that there have been significant increases in regulation and corporate governance (CG) reforms focusing on board composition following various corporate scandals in the past decades.

Boards of profit-orientated companies are usually composed of individuals that bring considerable expertise, experience and skills, each one within their own specialist field, such as financial experts, lawyers, marketing specialists, top management of other firms and community leaders (Hillman & Dalziel, 2003; Mitchell, Agle, & Wood, 1997). Similarly, based on the taxonomy of directors proposed by Hillman, Cannella, and Paetzold (2000), some corporate boards also compose of

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community leaders. This type of Non-Executive Directors (NEDs) are important to the corporation because they can provide immense information and experience on the impact of organizational activities on the society at large and its relationships with powerful community groups. To this extent, it can be argued that the presence of community leaders on corporate boards can contribute enormously to corporate legitimacy[1] by facilitating the acceptance of the company's operations by its external environment, i.e. the community, ensuring necessary corporate survival and success (Hillman et al., 2000; Hillman & Dalziel, 2003).

Furthermore, evidence on the growing importance of community leaders in the board's strategic decision making has started to emerge[2]. For example, in a study of the impact of environmental changes on board composition, Hillman et al. (2000) show that during shifts from a regulated to a deregulated environment, where business uncertainty increases, firms tend to increase the number of community influential figures on their boards. As the authors suggest (Hillman et al., 2000, p. 252), "Environmental jolts such as deregulation change the nature of the interdependencies and resource needs faced by the firm, thus altering the needs with respect to the extra-governance roles of directors".

This strategic move of including community influential figures on the board stems from firms' increasing need to adjust promptly to an uncertain business environment by allowing non-business perspectives and ideas to be heard; as well as, utilizing the directors' influence on various community groups (Hillman et al., 2000). These results, on the influence and growing importance of community representatives on the board, are further corroborated by Hillman and Keim (2001) who show a statistically significant positive relationship between the number of community directors and firm's performance on aspects of diversity[3].

One of the areas in which community leaders on the board could influence corporate actions is Corporate Community Involvement Disclosure (CCID)[4]. CCID is the disclosure, in annual reports, of the involvement of corporations in social initiatives in the communities in which they operate (Moon and Muthuri, 2006). Marquis et al. (2007, p. 926)[5], refer to the same idea as corporate social action, describing it as "behaviors and practices that extend beyond immediate profit maximization goals and are intended to increase social benefits or mitigate social problems for constituencies external to the firm". Similarly, Moon and Muthuri (2006) argue that Corporate Community Involvement (CCI) goes beyond donations to charities to include committing significant time and other company's resources such as money, skills and expertise to community projects and developments, including but not limited to arts, housing, the environment, poverty eradication, health and wellbeing, welfare and general improvements in the quality of life of the community. These CCI activities are undertaken not as a responsibility but as recognition of a deserving action by the corporation to its community of operations (Marquis et al., 2007).

The importance of CCI can be traced to the mid-20th century following the end of the war. Tallon (2010) argues that CCI was one of the strategies adopted for economic and social regeneration by the UK, US and other governments between the late 1940s and early 1960s due to the devastating effects of the World War II, such as poverty, unemployment and homelessness (Bush, Grayson, Jordan, & Nelson, 2008). Businesses were therefore encouraged to get involved in community development with the intention of increasing the rate of industrial and economic growth (Moon and Muthuri, 2006). Consequently, corporations moved from philanthropic activities prior to World War II, to actual involvement in community development and social rebuilding after the war through corporate social actions (Bush et al., 2008). In this sense, Matten and Crane's (2005) expositions on the pervading roles of corporations in discharging state-like responsibilities such as protecting, enabling and implementing citizenship right, and Scherer and Palazzo's (2011) arguments on the growing political role of firms are indicative of the importance of CCI and the significant roles of firms in the life of their community of operations.

Prior studies have suggested that social disclosure is positively related with increased social concern by the firm (Cho & Patten, 2007; Patten, 2002). Evidently, one of the most important tools for providing corporate legitimacy is the use of corporate disclosure and especially social reporting (Cho & Patten, 2007; Parker, 2011). Consequently, we argue that, pragmatically, firms need to constantly renew their legitimacy with their community of operation and this is achieved through effective communication (e.g. through corporate disclosure). Distrust could arise between a firm and its important stakeholders due to poor communication (Suchman, 1995) that could be counterproductive to the achievement of corporate goals (Bebbington, Larrinaga-González, & Moneva-Abadía, 2008; Mitchell et al., 1997). This is because, according to Clarkson (1995), the community is viewed as an important member of the stakeholder system that can disrupt the corporation's operations (for example, through sabotage or lack of patronage) if their expectations are not met.

[1] The term corporate legitimacy as elegantly defined by Suchman (1995, p. 574) "is a generalised perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs and definitions".

[2] In contrast to the literature on board composition for profit-orientated organisations, the role and contribution of community leaders in non-profit organisations is well documented (Provan, 1980; Garonzik, 1999; Alexander, Weiner, & Succi, 2000; Ingram, 2003).

[3] In the study of Hillman and Keim (2001), the variable 'Diversity' reflects issues such as the employment of women and minorities, existence of outstanding benefit programs addressing work/family concerns, taking over of innovative hiring initiatives or other programs directed at employment of the disabled, etc.

[4] Other ways through which community leaders could impact corporate action include corporate philanthropic decisions, appreciation of the impact of corporate action on community of operation and consequently leading to change in corporate strategy.

[5] We used corporate community involvement and corporate social action interchangeably in this paper because they essentially are referring to the same issue(s).

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