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Does board independence influence financial performance in IPO firms? The moderating role of the national business system

Alessandro Zattoni[a,*], Michael A. Witt[b], William Q. Judge[c], Till Talaulicar[d], Jean Jinghan Chen[e], Krista Lewellyn[f], Helen Wei Hu[g], Jonas Gabrielsson[h], Jose Luis Rivas[i], Sheila Puffer[j], Dhirendra Shukla[k], Felix Lopez[l], Emmanuel Adegbite[m], Yves Fassin[n], Sibel Yamak[o], Stav Fainshmidt[p], Hans van Ees[q]

[a] *Department of Business and Management, LUISS University and Business School, Viale Romania 32, Rome 00197, Italy*
[b] *Strategy Area, INSEAD, 1 Ayer Rajah Avenue, Singapore 138676, Singapore*
[c] *Management Department, Old Dominion University, 2126 Constant Hall, Norfolk, VA 23529, USA*
[d] *Department of Organization and Management, University of Erfurt, Nordhaeuser Str. 63, D-99089 Erfurt, Germany*
[e] *Xian Jiaotong-Liverpool University, Suzhou, China & Nankai University, China*
[f] *Department of Management and Marketing, University of Wyoming College of Business, Laramie, WY 82071, USA*
[g] *Department of Management and Marketing, University of Melbourne, 198 Berkeley St, VIC 3010, Australia*
[h] *Department of Business Studies, Halmstad University, P.O. Box 823, S-301 18 Halmstad, Sweden*
[i] *ITAM School of Business, Mexico DF, Mexico*
[j] *D'Amore-McKim School of Business, Northeastern University, 360 Huntington Avenue, Boston, MA 02115, USA*
[k] *Faculty of Engineering, University of New Brunswick, NB E3B 5A3 Fredericton, Canada*
[l] *Department of Accounting and Finance, University of Valladolid, 47002 Valladolid, Spain*
[m] *Department of Accounting and Finance, Leicester Business School, De Montfort University, LE1 9BH Leicester, UK*
[n] *Department of Innovation, Entrepreneurship and Service Management, Ghent University, Ghent, Tweekerkenstraat 2, 9000, Belgium*
[o] *Human Resources Department, University of Wolverhampton Business School, University of Wolverhampton, Wolverhampton, UK*
[p] *Department of Management and International Business, College of Business, Florida International University, Miami, FL, USA*
[q] *Department Global Economics and Management, University of Groningen, Groningen, Netherlands*

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ABSTRACT

Prior evidence suggests that board independence may enhance financial performance, but this relationship has been tested almost exclusively for Anglo-American countries. To explore the boundary conditions of this prominent governance mechanism, we examine the impact of the formal and information institutions of 18 national business systems on the board independence-financial performance relationship. Our results show that while the direct effect of independence is weak, national-level institutions significantly moderate the independence-performance relationship. Our findings suggest that the efficacy of board structures is likely to be contingent on the specific national context, but the type of legal system is insignificant.

1. Introduction

Scholars and regulators emphasize the crucial importance of adopting an "independent" board of directors, i.e., one with a majority of nonexecutive directors (Bell, Moore, & Filatotchev, 2012). The underlying assumption is that independent boards are essential for preventing self-serving behavior by top management or controlling shareholders and for providing objective oversight of strategy formation and execution (Hillman & Dalziel, 2003; Zattoni & Cuomo, 2010). Due to the conceptual power of agency theory and the growing influence of institutional investors, this "board independence norm" (BIN) has become enshrined in corporate governance regulations and codes throughout the global economy (Johanson & Ostergren, 2010) and is shaping board characteristics of many companies going public through initial public offerings (IPOs).

* Corresponding author. Tel.: +0039 06 85225220.
E-mail addresses: azattoni@luiss.it (A. Zattoni), michael.witt@insead.edu (M.A. Witt), wjudge@odu.edu (W.Q. Judge), till.talaulicar@uni-erfurt.de (T. Talaulicar), j.chen71@liverpool.ac.uk (J.J. Chen), klewelly@uwyo.edu (K. Lewellyn), hehu@unimelb.edu.au (H.W. Hu), jonas.gabrielsson@hh.se (J. Gabrielsson), jose.rivas@itam.mx (J.L. Rivas), s.puffer@neu.edu (S. Puffer), dshukla@unb.ca (D. Shukla), flopez@eco.uva.es (F. Lopez), emmanuel.adegbite@dmu.ac.uk (E. Adegbite), fassin@skynet.be (Y. Fassin), S.Yamak@wlv.ac.uk (S. Yamak), sfainshm@fiu.edu (S. Fainshmidt), h.van.ees@rug.nl (H. van Ees).

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Previous studies on corporate governance of IPOs have explored the impact of board independence on a number of IPO outcomes (e.g., Bell et al., 2012; Chahine & Filatotchev, 2008; Chahine & Goergen, 2013; Chancharat, Krishnamurti, & Tian, 2012; Filatotchev & Bishop, 2002). Most of these studies have analyzed the independence-performance relationship in single countries, typically developed economies such as the U.S. or, to a lesser extent, the U.K. In this fairly unique Anglo-American governance environment characterized by liquid markets, dispersed ownership, an entrepreneurial social culture, and relatively strong investor protections, these studies generally find that board independence may decrease underpricing (Chahine & Filatotchev, 2008; Filatotchev & Bishop, 2002), increase the likelihood of corporate survival (Chancharat et al., 2012), and support IPO success (Bell et al., 2012).

However, very little is known about the board independence-financial performance relationship outside the Anglo-American institutional context. Only recently has research extended the investigation of this relationship to other economies (e.g., Bertoni, Meoli, & Vismara, 2014; Lin & Chuang, 2011), revealing different results from prior studies using U.S. samples. Moreover, while we do know that the quality of the legal system appears to influence IPO underpricing (e.g., Boulton, Smart, & Zutter, 2010) and may interact with board independence to affect IPO firm success (e.g., Bell et al., 2012; Chahine & Saade, 2011), there is no study that we are aware of that has used a cross-national sample to explore systematically how the wider national institutional context moderates the board independence-financial performance relationship. As a result, we still do not know how and under what conditions the BIN affects financial performance more generally (Peng, Buck, & Filatotchev, 2003).

To help answer these questions, we examine the relationship between board independence and market-based measures of financial performance for a global sample of domestic IPO firms based in eighteen different developed and emerging economies. Our central theoretical premise is that the board independence-financial performance relationship can be understood only after considering the embedded nature of the IPO firm within a wider national institutional system. Specifically, we argue that formal and informal national institutions may amplify or attenuate the effect of BIN on financial performance for IPO firms. Consistent with that premise, our empirical findings reveal that there is a weak positive relationship between board independence and financial performance after the IPO event. However, when we consider the moderating effects of the four dimensions of the national business system (NBS) highlighted by Whitley (1999), the effect is much clearer and more compelling.

These findings provide significant contributions to the literature on IPO firms, comparative institutional analysis, and corporate governance. First, we extend previous studies on IPO board independence and financial performance developed within Anglo-American countries by showing the significant moderating role of national institutions in multiple governance environments. In doing so, we help shed light on the boundary conditions of the efficacy of the BIN in particular and of agency theory in general. Second, our findings have important implications for comparative institutional analysis, as they direct researchers' attention to a more holistic and nuanced understanding of the overall national business system by including a large and theoretically comprehensive set of both formal and informal institutions. Third, we demonstrate that complementarity and substitution effects do not involve only the various governance mechanisms developed at firm-level (e.g., board monitoring versus managers' incentives), but characterize also the interaction between firm-level governance mechanisms and country-level institutions.

2. Theoretical development

2.1. The contribution of nonexecutive directors to IPO financial performance

Boards of directors of entrepreneurial firms play a crucial role in helping firms pursue their growth prospects and overcome the complexities associated with their transition from private to public ownership (e.g., Bruton, Filatotchev, Chahine, & Wright, 2010; Certo, Holcomb, & Holmes, 2009). Based on this premise, and consistent with good governance codes' recommendations, firms going public usually increase board independence and appoint new nonexecutive directors in order to acquire additional knowledge and skills and increase legitimacy among external shareholders and stakeholders (Certo, 2003). More specifically, nonexecutive directors are expected to support post-IPO results by actively contributing to the board monitoring role and/or to the board service role (e.g., Chahine & Filatotchev, 2008; Kor, Mahoney, & Watson, 2008; Melkumov, 2009).

With regard to board monitoring, nonexecutive directors may mitigate agency costs by aligning the interests of powerful actors (e.g., full-time executives or controlling shareholders) with the interests of the firm (Jensen & Meckling, 1976). First, nonexecutives can improve the ability of the board to monitor firm performance or to assess top management's or controlling shareholders' behavior, e.g., by determining if they are diverting corporate resources through self-dealing transactions or by deciding a fair compensation for board members (e.g., Hillman & Dalziel, 2003; Zattoni & Cuomo, 2010). Moreover, nonexecutive directors can improve IPO board accountability and reputation by guaranteeing its independence from powerful actors, and in doing so may contribute to firm performance in a critical phase of the company life-cycle (e.g., Chahine & Goergen, 2013; Lin & Chuang, 2011).

Nonexecutive directors can also provide valuable services to boards by offering additional expertise and competencies, broadening their knowledge base for key decisions, contributing actively to the strategic decision-making process, and securing access to critical resources (e.g., Hillman & Dalziel, 2003; Min & Smyth, 2014; Pfeffer & Salancik, 1978). In the context of IPOs, by bringing different perspectives and experiences to board decision making (Hillman & Dalziel, 2003), nonexecutive directors can help company insiders to lead the firm strategically in the aftermath of the IPO and to deal successfully with the complexities associated with the transition to public company status (Filatotchev & Bishop, 2002). Beyond this, nonexecutive directors can provide access to critical resources (like financial capital, political influence or critical information), which may help IPO firms deliver expected results (Hillman & Dalziel, 2003; Kor et al., 2008).

2.2. National institutions, corporate governance and firm performance

Scholars recognize that governance mechanisms, such as the board, are strongly influenced by national institutions (e.g., Aguilera & Jackson, 2003; Redding, 2005). Institutions are defined as "the rule of the game in a society" or, more formally, as "the humanly devised constraints that shape human interaction" (North, 1990: 3). Institutions play an important role in our societies, as they provide the stability and predictability necessary for market and social exchanges among individuals and organizations.

Institutions may be either formal or informal (e.g., North, 1990; Peng, Wang, & Jiang, 2008). Formal institutions are codified rules, such as laws and regulations. Informal institutions are intangible values, customs and traditions related to culture. International business literature recognizes that institutions affect national business systems as they reduce uncertainty, shape human interactions and favor the

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