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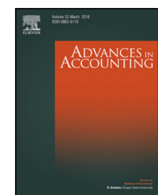

The impact of board quality and nomination committee on corporate bankruptcy

Kingsley Opoku Appiah [a,*], Amon Chizema [b,1]

[a] School of Business, KSB Building Room TF 04, Kwame Nkrumah University of Science and Technology, Kumasi, Ghana
[b] Birmingham Business School, University of Birmingham, Edgbaston, Birmingham, B15 2TT, United Kingdom

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A B S T R A C T

This paper examines the effects of board quality on the relationship between corporate bankruptcy and nomination committee effectiveness. We argue that the proportion of outside directors, a proxy of board quality, arguably captures the extent of board control and resources. Based on dataset from 1835 firm-year observations for 98 bankrupt and 269 non-bankrupt UK listed non-financial firms between 1994 and 2011 and using the agency and resource dependence theories, we predict and find that nomination committee effectiveness negatively affects corporate bankruptcy and that board quality mitigates the negative effects. The results lend support to the notion that firms benefit from board quality in terms of outside directors' ability to monitor CEO on behalf of shareholders and also provide advice, counsel and legitimacy to the firm. This study extends the present research on corporate bankruptcy by providing evidence on the impact of board quality and nomination committee effectiveness on UK corporate bankruptcy.

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1. Introduction

This study is motivated by schemes to strengthen the effectiveness of corporate boards and their committees, in the wake of extraordinary profile corporate bankruptcy. For instance, Cadbury (1992) requires listed firms to establish a proper, rigorous and clear system for new board candidates. Cadbury (1992) also recommends that the majority of members on the nomination committee should be non-executive directors. Higgs (2003) approves Cadbury's (1992) recommendation of the nomination committee, emphasising on its main role and responsibilities. Integral in the nomination committee reforms is that an effective nomination committee enhances the board's ability to discharge their monitoring and resource functions effectively (Hillman & Dalziel, 2003), thereby mitigating the negative association between board quality and corporate bankruptcy (Platt & Platt, 2012).

Scholars use the agency (Jensen & Meckling, 1976), social network (Granovetter, 1985), stewardship (Davis, Schoorman, & Donaldson, 1997), institutional (DiMaggio & Powell, 1983) and resource dependence (Pfeffer & Salancik, 1978) perspectives to understand corporate board attributes and corporate financial performance (Giráldez & Hurtado, 2014). Little, however, is known about the effects of the board quality and nomination committee on corporate bankruptcy, despite series of board composition and nomination committee's guidance in the Anglo-Saxon literature (Ruigrok, Peck, Tacheva, Greve, & Hu, 2006). This study contributes to this line of research. Using dataset from 1835 firm-year observations for 367 UK listed non-financial firms, consisting of 98 bankrupt and 269 non-bankrupt firms, drawn from the top 500 UK listed firms, from 1994 to 2011, the study investigates the effects of board quality on the relationship between nomination committee effectiveness and corporate bankruptcy. We use proportion of outsider directors as proxy for board quality. Proportion of outside directors (i.e. ratio of outside directors to board size) mirrors the degree to which the CEO controls the board and vice versa (Wincent, Anokhin, & Örtqvist, 2012). In addition, Pfeffer and Salancik (1978) suggest proportion of outside directors reflects the characteristics of the firm's environment, enhancing the firm's ability to access resources required to control uncertainty and thus avoid corporate bankruptcy. We argue that the effects of nomination committee effectiveness and corporate bankruptcy will be affected by board quality. Further, we contend that while nomination committee effectiveness is a necessary condition to prevent corporate bankruptcy, nomination committee effectiveness on its own is not sufficient to prevent corporate bankruptcy—we also need to consider the number of outside directors on the board to discharge their functions because their ability to control their CEOs' agenda and provide resources to the firm differs (Jermias & Gani, 2014). For instance, companies Non-bankrupt and Bankrupt have

* Corresponding author at: TF04 (Ayim Complex Building), Department of Accounting and Finance, School of Business, Kwame Nkrumah University of Science and Technology, Kumasi, Ghana. Tel.: +233 548374634, +233 262888126.
E-mail addresses: koappiah.ksb@knust.edu.gh (K.O. Appiah), A.Chizema@bham.ac.uk (A. Chizema).
[1] Tel.: +44 121 414 2273.

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the same level of effectiveness for the board nomination committee. Company Non-bankrupt board, however, is outside dominated but not company Bankrupt, implying approval of the NC's decisions may be in the interest of shareholders but not the CEO. Accordingly, it is logical to expect that company Non-Bankrupt's board of directors will use the breadth and depth of their expertise to provide advice and counsel (Zahra & Pearce, 1989). These in turn, will enhance company Non-Bankrupt's legitimacy (Daily & Schwenk, 1996), thereby facilitating access to critical resources required to avoid corporate bankruptcy (Hillman, 2005).

Consistent with agency theory and resource dependence theory, we predict that nomination committee effectiveness will have a negative effect on corporate bankruptcy while board quality will also have a negative effect on corporate bankruptcy. The negative effect of nomination committee effectiveness will be mitigated by the board quality. We find that nomination committee effectiveness displays a negative but insignificant relationship with corporate bankruptcy. With regard to board quality, we document a negative relationship between board quality and corporate bankruptcy. We also find that board quality mitigates the negative effects between the nomination committee effectiveness and corporate bankruptcy.

This study's contributions are several. First, the use of agency and resource dependency theories in this study has shown that the proportion of outside directors is significant signposts to the corporate bankruptcy event. The results increase our understanding of the link between board quality and corporate bankruptcy. Thus, we have evidence to support to the notion that outside dominated boards exhibit a positive association with effective board control (Johnson, Daily, & Ellstrand, 1996) and resource provision function (Fich, 2005; Pearce & Zahra, 1991; Pfeffer, 1972) and, thus, thereby reducing corporate bankruptcy. Second, the findings suggest the negative but insignificant relationship between nomination committee effectiveness and corporate bankruptcy. However, the negative effect is mitigated by the board quality. To the best of our knowledge this area is under research. Platt and Platt (2012), for example, consider a direct link between nomination committee's variables and corporate bankruptcy, neglecting a comprehensive analysis of corporate bankruptcy and the interaction between board quality and nomination committee effectiveness. Platt and Platt's approach limits our understanding of the effects of nomination committee on corporate bankruptcy. Put differently, the use of agency and resource dependence theories in this study has shown that the effectiveness of the nomination committee contributes towards our understanding of the relationship between board quality and corporate bankruptcy. These findings lend support to the notion that well run board nomination committee strengthened the board quality to monitor managerial performance and in this way, reduces corporate bankruptcy. Finally, this study adds to existing research on nomination committee that mirrors the recommendations of the Cadbury (1992) on the board nomination committee, emphasising on its formal presence, size, membership independence and meetings of the nomination committee.

2. Literature review and hypotheses

2.1. Agency theory and the monitoring function

The separation of ownership and control in listed firms has induced acute agent–principal conflict regarding the firm's strategic direction. Managers seek personal wealth and are less interested in enhancing the shareholders' value (Baysinger, Kosnik, & Turk, 1991). Agency scholars, therefore, advocate enhanced monitoring of the CEO's agenda (Combs, Ketchen, Perryman, & Donahue, 2007) as well as incentives that tie executives' rewards to shareholders' value to lessen the agency loss (Eisenhardt, 1989) via reducing the moral hazards and adverse selection problems (Gomez-Mejia & Wiseman, 2007), and ultimately, reducing the bankruptcy of the firm (Jensen & Meckling, 1976). These duties fall first to the board, outside directors and nomination committees, in particular (Combs et al., 2007). Monitoring by nomination committee enhances the quality of board composition. Board quality, in turn, reduces the agency problems and, in this way, mitigates the negative relationship between nomination committee and the likelihood of a firm's bankruptcy (Hillman & Dalziel, 2003). Consequently, the study examines the effects of board quality and nomination committee effectiveness on corporate bankruptcy through the agency-theoretical lens.

2.2. Resource dependence theory and the provision of resource function

The resource dependence theory suggests that corporate bankruptcy is an indication of a firm's lack of legitimacy to access critical resources from its constituents (Pfeffer & Salancik, 1978). This suggests that firm interdependence with exchange partners reduces its independence and increase uncertainty (Eisenhardt, 1989). In turn, uncertainty obscures the firm's control of resources (Rivas, 2012) thereby, reducing shareholders' value (Combs et al., 2007). To mitigate this, BOD links the firm with its external environment, thereby reducing uncertainty (Rivas, 2012), and enhancing firm's long-term viability (Hillman & Dalziel, 2003).

Overall, agency and resource dependence theories draw on diverse disciplines, but complement each other in identifying essential board attributes that might affect corporate bankruptcy. Accordingly, we invoke Hillman and Dalziel (2003) assertion that the resource dependence and agency theories suggest an integrative model that synthesises prior studies and specifies relationships between board quality and nomination committee effectiveness on corporate bankruptcy.

Second, the resource dependence theory suggests that boards, via their interlocks, provide resources including legitimacy, advice and counsel. Thus, boards via their network ties enhance firms' legitimacy (Hillman & Dalziel, 2003), which in turn, reduces uncertainties (Borgatti & Pacey, 2003), thereby inducing exchange partners for continual support to enhance firm's long term success.

2.3. Nomination committee, board quality, and corporate bankruptcy

The significance of board diversity has been increasingly recognised especially after the recent financial fiascos and high profile bankruptcies (Kaczmarek, Kimino, & Pye, 2012). Nomination committees (NCs) help to ensure the “right” candidates are selected on the board (Ruigrok et al., 2006). Interdependent directors may not perform their duties in the manner compatible with shareholder interests. The NC is a crucial institutional mechanism to overcome the limitations of the board selection process (Kaczmarek et al., 2012). Here, NCs resolve the power asymmetry between boards and management (Ruigrok et al., 2006) by raising directors' qualifications and independence. Thus, the absence of nominating committees is associated with more affiliated outside directors, who lack the confidence to evaluate CEO's performance (Shivdasani & Yermack, 2002). In turn, poor evaluation of the CEO may result in excessive cash compensation for CEOs (Westphal & Zajac, 1995), thereby resulting in a firm's bankruptcy. The existence of the NC effectively delegates the director selection process to an independent group, powerful enough to recruit independent thinkers who possess the necessary expertise to accomplish their role. Conversely, the NC's decisions are ratified by the board, implying that the board nomination process is a function of the distribution of power between the board and the CEO. The mere presence of the NC is not sufficient to mitigate the agency problem and/or enhance survival of a firm. An inside director, for example, serving on the NC is more likely to safeguard shareholders' interest (Ruigrok et al. (2006), thereby resisting the appointment of independent thinkers. ICSA (2007) also highlights that the NC should meet at least twice in the financial year to discharge their duties effectively. Fama and Jensen (1983) suggest that firms can reduce the agency

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