



Board independence, corruption and innovation. Some evidence on UK subsidiaries



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ABSTRACT

In this paper we test the hypothesis that independent boards can insulate a company from the detrimental impact of corruption on its performance (proxied by innovation). To this purpose, we have estimated an innovation production function that links innovation outputs to innovation input (namely investment in R&D) on a sample of manufacturing subsidiaries controlled by British multinationals and located in 30 countries. Our analysis covers the period 2005–2013. After controlling for the subsidiary's characteristics (including the ownership structure and whether the main shareholders are from Common Law countries), we find that independent boards may mitigate the negative impact of corruption on innovation as subsidiaries located in more corrupt countries and with more independent boards tend to invest more in R&D and register more valuable patents. These results still hold after controlling for the average age of the directors, the proportion of directors with no local business affiliations and government effectiveness.

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1. Introduction

The influence of the board structure on the performance of a company is one of the most active research areas in corporate finance (Dahya et al., 2008; Aggarwal et al., 2008; Bruno and Claessens, 2010; Black and Khanna, 2007; Dahya and McConnell, 2007). According to Fama and Jensen (1983), the board has two main functions: monitoring the senior management to protect the company against fraudulent behaviour and advising the management on the strategic direction taken by the company. The optimal board structure is then a function of the costs and benefits associated to the two functions, given the characteristics of the firm and its economic environment (Kim et al., 2007).

Conventional wisdom suggests that boards with a large proportion of outside directors (i.e. more independent boards) may be effective monitors and have a positive impact on the company's performance. Empirical research tends to support this view. Indeed, cross-country studies have shown that board independence is significantly and positively related to firms' performance (Dahya et al., 2008; Aggarwal et al., 2008; Bruno and Claessens, 2010) while single-country studies have shown that the independence of the board is particularly relevant to companies that are located in countries with weak protection of the investors rights

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(Black and Khanna, 2007; Dahya and McConnell, 2007) consistently with the view that internal governance mechanisms (such as board structure in this case) are responses to firms' contracting and operating environments. Unsurprisingly then, it is commonly believed that the independence of the board is a key feature of a well-run company (Liu et al., 2015) and several countries have adopted legislation demanding higher representation of outsiders on the boards of publicly traded companies.¹

Are the benefits of an independent board limited only to the protection of the minority shareholders from the risk of expropriation? In this paper, we argue there are additional benefits that may accrue to a company from having an independent board. More specifically, we suggest that independent boards can mitigate the impact of corruption on business performance. Corruption is usually the outcome of dysfunctional institutions and it can have a disruptive impact on a company: for example, corruption increases the costs of obtaining loans and licences (Fan et al., 2008; Lemma, 2015) and reduces the propensity to invest in innovation (Mahagaonkar, 2008). Although the impact of corruption is well understood, the mechanisms that companies can use to mitigate the risk of corruption are less so. Some authors have pointed out that in weak institutional environments the design of the internal governance mechanisms is critical for a company to mitigate the effects of the local institutions and perform well (La Porta et al., 1998; Klapper and Love, 2004). These typically include the board of directors and while the notion that boards can shelter companies from corruption is accepted, very little is known about the desirable board structure in corrupt countries. In this paper we suggest that independence from the top management is the key feature of boards that are effective in insulating a company from corruption.

For our analysis, we focus on the board of directors among multinational subsidiaries. This is an interesting group of firms to analyse for several reasons: first, multinationals tend to be very sensitive to the levels of corruption in the host country. Indeed, corruption tends to increase the costs of operating abroad while decreasing the return on foreign investment (Wei, 2000; De Rosa et al., 2010). Ultimately, multinationals prefer not to invest in countries characterised by high levels of corruption and if they do so, they prefer partnerships to equity modes. Second, because of the strategic nature of FDI, multinationals use a variety of corporate governance mechanisms to control their investment and ensure that they are not expropriated either by local managers or by other shareholders. Therefore, it is expected that boards may play a key role in the structure of the governance that multinationals adopt when investing abroad although there is no evidence on whether there is a desirable board structure in these cases. Finally, recent high-profile cases of corruption among multinational subsidiaries² have put the board structure under the limelight and therefore an analysis of whether the board structure is an effective mechanism to insulate affiliates' performance from corruption is rather timely.

Against this background, the main purpose of this paper is to explore whether in more corrupt countries subsidiaries with more independent boards perform better than subsidiaries with less independent boards after controlling for a set of characteristics of the subsidiary and of the board itself. In a set of robustness tests, we explore whether it is really independence that matters for a well performing company in a corrupt country or rather there are other characteristics of the board that are equally important. We therefore test whether the relationship between independence of the board and R&D intensity still holds after controlling for other characteristics of the directors. In particular we focus on the directors' average age (as a proxy for their experience) and on the connections they have with foreign companies. This way we eventually provide some useful empirical evidence on the desirable structure of the directors' boards among affiliates in corrupt countries.

Unlike previous papers in this area, we focus on innovation as our indicator of business performance rather than on the company's financial performance or its market value. This is in itself a novelty of the paper. Although a few papers have analysed the relationship between independence of the board and firm performance, hardly any has focused on innovation as a business outcome. Still innovation underpins business growth and eventually financial performance as innovative firms tend to be more productive and profitable. Eventually, they perform better on the financial markets and can attract external funding. In addition, the relationship among innovation and corruption is relatively underexplored. Whether innovation is negatively associated to the level of corruption in a country is unclear. It is commonly argued that innovation can be stifled in corrupt countries as bribes can subtract resources that could be otherwise used by companies to invest in R&D.³ The main argument is that innovation is a complex process with uncertain output (i.e. the actual invention) and corrupt managers can exploit this uncertainty to divert resources for their private benefit and allow R&D projects to fail while blaming the uncertainty of the process for the failure. However, it has also been argued that bribes can reduce the risk of bureaucratic expropriation with the result that companies may be more willing to invest in R&D projects with more uncertain outcomes. Interestingly, Shleifer and Vishny (1993) find that corrupt firms would often report having advanced technologies even though they are not necessary.

To model the relationship among corruption, propensity to innovate (or number of innovations) and internal corporate governance mechanisms (i.e. ownership concentration and structure of the board), we estimate an innovation production function that links innovation outputs to innovation input (namely investment in R&D). We use two measures of innovation outputs: the number of patents registered with the European Patent Office (EPO) by the affiliate in a given year and the cumulated sum of forward citations that the patents have received. Patents are a common indicator of business innovation. However, not all the patents have the same value as some innovations may be more valuable than others. For these reasons, we use the number

¹ See the Sarbanes-Oxley Act for US. In the UK, the corporate governance code requires firms to appoint to their boards a majority of independent directors.

² The bribery scandals that have involved Walmart in Mexico and Avon in China have highlighted the weaknesses of their governance. Also, empirical evidence suggests that affiliates in foreign countries are as likely as their domestic counterparts to engage in corruption (Hellman et al., 2002). The Transparency International Bribe Payer Index shows that companies from leading exporting countries are the most likely to pay bribes in foreign countries. Gueorguiev et al. (2011) show that affiliates tend propensity to pay bribes in sectors that offer higher rents.

³ Mahagaonkar (2008) provides some evidence showing that corruption can affect negatively product innovation.

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