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Are all regulatory compliant independent director appointments the same? An analysis of Taiwanese board appointments

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ABSTRACT

Globally many regulators adopted a rules-based approach to independent director appointments stipulating '*independence*' criteria. This paper investigates whether partitioning a regulatory compliant sample of independent director appointments by prior affiliation to the board influences the relationship between ownership and control rights, and performance. We report a significant positive relationship between board independence and controlling shareholders' cash-flow rights for firms where the appointee had prior affiliation to the board, but no performance improvement. Firms where the regulatory compliant independent directors had no prior-affiliation to the board experienced significant improvement in firms' next period Return-on-Assets. Appointing affiliated directors is indicative diminished board quality, which is consistent with the empirical evidence that controlling shareholders determine board quality to accommodate tunneling to extract the private benefits of control to compensate for significant additional costs associated with concentrated ownership (Yeh and Woidtke, 2005; Luo et al., 2012; Liu et al., 2015). The positive association between performance and unaffiliated independent directors suggests a desire to introduce expertise to receive benefits via improved firm performance which is consistent with the literature, mostly from studies of emerging markets, reporting a causal link from independent directors to firm performance (Choi et al., 2007; Dahya et al. 2008; Liu et al., 2015).

1. Introduction

Inadequate corporate governance systems were believed to have contributed to, and exacerbated, the 1997–98 Asian financial crisis which provided impetus for reform in the region (Rajan and Zingales, 1998; Prowse, 1998; Organization for Economic Co-operation and Development (OECD), 1999; Johnson et al., 2000a). A central tenet of Taiwan's reform package included enhancing board independence. Policy makers succumb to the conventional wisdom and recommended the introduction of the independent director system. From February 2002 listed firms were advised to appoint at least two independent directors and one independent supervisor to their board, whereas for new listings it was compulsory. Consequently, Taiwanese boards

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experienced a significant increase in the reported number of independent board member appointments over a concentrated period of time following the introduction of the voluntary governance code in 2002 (Liu and Yang, 2008; Young et al., 2008).

Taiwan is an environment where controlling shareholders have overwhelming power to influence board composition with the 2002 governance reforms providing an institutional setting akin to a natural experiment (Filatotchev et al., 2005; Strange et al., 2005, Yeh and Woidtke, 2005; Chou et al., 2013). Consistent with agency theory and empirical evidence, we proceed on the working assumption that controlling shareholders are self-interested and will only enhance board independence if they believe it is in their interest to do so (Claessen et al., 2002; Claessen et al., 2006; Yeh and Woidtke, 2005; Dahya et al., 2008; Masulis et al., 2009; Liu et al., 2015). This paper evaluates the relationship between independent director appointments and the extent to which controlling shareholder's cash-flow rights influence appointments, and if the definition of '*independence*' influences this relationship and subsequent firm performance.

Initially, we evaluate the full sample of firms comprising regulatory compliant independent director appointments. Consistent with the literature for emerging markets characterized by concentrated ownership we find that cash-flow rights (ownership) is significantly positively correlated with board independence whereas excess control rights (deviation of cash-flow from control rights) is significantly negatively correlated with board independence. Typically, these findings would be attributed to the incentive-alignment and entrenchment hypotheses. Next, we examine the impact of prior-affiliation to the board. Empirical evidence highlights the importance of social ties when determining independence beyond conventional regulatory definitions. Hwang and Kim (2009) report that US boards went from being 87% independent under the conventional definition of independence to 62% when informal ties between directors and CEOs were accounted for. Likewise, in Taiwan, Liu and Yang (2008) report that the majority (58.4%) of board member appointments announced in 2002 as '*new*' independent directors sat on the board of the same company in 2001. When we partition our sample by affiliated and unaffiliated independent appointments we find that cash-flow-rights are only significantly positively correlated with the appointment of affiliated independent directors, but had no influence on the appointment of unaffiliated independent directors. The positive association between controlling shareholders cash-flow-rights and the appointment of affiliated directors in Taiwan can be interpreted as reflecting the desire of controlling shareholders to diminish board quality (Yeh and Woidtke, 2005). Luo et al. (2012) provide a more sophisticated analysis for this result than is typically cited in the literature. They argue that controlling shareholders are subject to significant additional costs as block shareholders including additional risk from a lack of diversification, additional costs for information collection, processing and monitoring management, and are exposed to liquidity restrictions which results in a high discount on block shares' price in comparison to otherwise identical stock. Over low-to-medium levels of ownership incentive-alignment effects dominate which act as a substitute for independent directors and therefore predicts a negative relationship and a reduction in tunneling. While from medium-to-high levels of ownership costs increase exponentially and as a consequence controlling shareholders has an incentive to extract the private benefits of control via tunneling. This model argues that a positive association over medium-to-high levels of ownership reflects an entrenchment effect. In the context of our analysis the decrease in board quality from appointing affiliated independent directors is consistent with a desire to accommodate tunneling which may also explain the lack of any relationship between affiliated independent director appointments and performance given that "*tunneling*" in practice involves controlling shareholders' extracting the private benefits of control which involving the transfer of assets and profits out of firms via transfer pricing, subsidized personal loans, related party transactions, outright theft, higher CEO compensation and value-destroying acquisitions (La Porta et al., 2002; Masulis et al., 2009; Su et al., 2008).

Stronger more independent boards have been credited with performance improvements for firms characterized by concentrated ownership (Bae et al., 2002; Dahya and McConnell, 2007; Dahya et al., 2008; Young et al., 2008; Black and Kim, 2012; Liu et al., 2015). We find a significant positive relationship between unaffiliated independent director appointments and subsequent firm performance reflected in a significant increase in next period Return-on-Assets. Whereas it was statistically insignificant for affiliated independent director appointments. A consistent robust finding throughout our analysis is a concave-quadratic relationship between board size and the demand for independent directors. This specification entered our analysis primarily as a control variable. The consistency of this relationship throughout our analysis provides a pointer for further research.

Our findings provide important insights for Taiwan and the general literature on board independence. Our initial results showing statistically significant relationships for measures of incentive-alignment and entrenchment are consistent with the extant literature. When prior-affiliation to the board is introduced to the analysis only affiliated appointments are statistically significantly correlated with controlling shareholders cash-flow rights. However, in terms of performance, improvements are driven by unaffiliated independent directors. It's important to remember our analysis is predicated on the assumption that controlling shareholders have the power to appoint who they choose: affiliated or unaffiliated. It appears from our analysis that when they desire performance improvement they appoint unaffiliated expertise, whereas when they wish to accommodate tunneling to provide a substitute channel to compensate for the costs of block ownership they reduce board quality by appointing affiliated independent directors.

Generally, it is important to note that in a voluntary enhancement institutional environment controlling shareholders chose a mix of independent directors whom they knew previously and who were new to the board, who then appear to have made different contributions. We posed the question: are regulatory compliant independent director appoints all the same? Our analysis clearly demonstrates that their contributions differ. From a regulator's perspective a natural question, or thought experiment, to conduct is to ask if these appointments were in the best interests of all stakeholders including minority shareholders and can these insights provide a policy recommendation to improve the rules-based appointment criteria? If performance benefits can be attributed to the appointment of unaffiliated independent directors, the question arises whether it is in everyone's best interest for regulators to stipulate unaffiliated independent appointments to boards of firms where controlling shareholders have