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Relationship between boardroom independence and corporate performance: Reflections and perspectives

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ABSTRACT

The perceived economic value of an independent boardroom configuration has progressively emerged as a matter of considerable importance in the academic and popular literature. The normative research paradigm has fundamentally been dominated by positivists who formulate inferential models populated by large sets of archival data. Regrettably, however, several decades of intense inquiries and passionate debates have invariably failed to ascertain (or dispel) the economic value of an independent boardroom configuration. The lingering boardroom independence–corporate performance saga has reached an impasse with no clear resolution in the foreseeable future. In this study, I provide a diagnosis (through the thematic analysis of semi-structured interviews) of why the economic viability of an independent boardroom remains an elusive phenomenon for positivist researchers. A central reason for the research impasse is attributed to ontological complexities intrinsic to the very nature of the corporation, compounded by multiple layers of methodological complexities. Ultimately, the disentanglement of this enigma would require a pivotal reconceptualization of the corporate governance research agenda.

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1. Introduction

Corporate governance could be conceptualized as the set of rules, policies, and procedures that define and delimitate the rights and the responsibilities of the central organizational players to ensure that the organization is directed and run in conformity with embedded principles, core values, and intended objectives. One paradigm model for effective corporate governance relies on the minimization of agency costs through an independent boardroom configuration. Undoubtedly, a predominantly independent boardroom is less vulnerable to conflicts of interest and other forms of agency biases than a predominantly dependent boardroom. By decreasing the agency cost of the firm, an independent boardroom is expected to steer the corporation in the direction of more favorable outcomes. The considerable practical importance of boardroom independence in the marketplace is evidenced by the fact that it has become a recurring theme in the multiplicity of influential corporate governance guidelines and codes of best practices around the world. Notwithstanding the intuitive economic benefit of a predominantly independent boardroom, the academic literature has relentlessly failed to unequivocally establish the directional superiority of a specific boardroom configuration.

A close examination of the prevailing empirical research reveals that there are widely divergent opinions regarding the presumed economic benefit of an independent boardroom. One stream of research suggests that boardroom independence positively impacts on corporate performance (e.g., Rosenstein and Wyatt, 1990). Conversely, another stream of research refutes the aforementioned proposition by ascertaining that boardroom independence actually erodes corporate value (e.g., Agrawal & Knoeber, 1996). Other streams of research offer diverging viewpoints by claiming that boardroom independence has neither beneficial nor adverse impacts on corporate performance, either explicitly or implicitly (e.g., Dulewicz & Herbert, 2004). The lack of consensual agreement on the economic superiority of an independent boardroom configuration is puzzling and thus warrants further scrutiny. In this study, I identify the ontological complexities and associated epistemological gaps that hinder researchers' ability to unravel a robust linkage between boardroom independence and corporate performance.

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2. The agency cost paradigm

2.1. Corporations with diffuse shareholders

In a shareholder-driven context characterized by the separation of ownership and control, the corporate governance paradigm centers on control mechanisms that would minimize the agency cost of the firm. The agency cost is the additional layer of cost above and beyond nonagency relationship borne by the principal consequent to the unwarranted behavior of the agent. In a typical corporation, the professional managers act as agents on behalf of passive shareholders. The agency cost starts with the premise that managers (notably the CEO) are not necessarily principled individuals. Thus, they may indulge in opportunistic maneuverings that would erode the firm value. The agency cost is particularly pronounced in the case of highly dispersed shareholders because of the relatively high asymmetry in information and power between the passive suppliers of finance (the shareholders) and the managers (Fama, 1980; Jensen and Meckling, 1976; Jensen, 1986; Agrawal & Knoeber, 1996; Fama and Jensen; 1983). It is therefore incumbent on the board of directors to reduce the agency cost of the firm by diligently overseeing the corporation and scrupulously upholding managerial accountability. Specifically, it is incumbent on the board of directors to recruit, select, mentor, incentivize, compensate, and terminate the CEO. The directors are also expected to formulate a CEO succession plan and act swiftly and decisively during crisis situations. Ultimately, the board of directors is expected to shape and regulate organizational behavior by inducing the CEO to make thoughtful and rational decisions that would increase the economic value of the firm.

2.2. Boardroom compositional independence

Traditionally, the definition of independent directorship has been confined to the sole employment status, thus the distinction between executive directors (or inside directors) and nonexecutive directors (or outside directors). For all practical purposes, an inside directorship position basically implies that "management is overseeing management," a situation that would certainly stifle the ability of the directors to exercise their fiduciary duties in all adequacy. The inside directorship position is also conducive to an awkward interaction between CEO and inside directors. On the one hand, the inside directors are expected to be the superiors of the CEO in the boardroom. On the other hand, the inside directors are expected to be the subordinates of the CEO during the day-to-day operations of the firm. This dichotomy (being a superior in one situation while being a subordinate in another situation) is marred with egregious conflicts of interest and self-serving biases, thus creating ample opportunities for political maneuverings, including organizational collusions and partisan interests. Conventional wisdom suggests that an inside director would fundamentally be inept to monitor and assess the CEO performance in all equanimity.

With the passage of time, the definition of directorship independence has become broader in scope than just the sole employment status. A director is considered independent if the individual is immune to self-serving biases that may hamper objective and impartial opinion in the boardroom. To fulfill the independent judgment condition, a directorship position ought to be devoid of noticeable or subtle conflicts of interest consequential of direct or indirect affiliations with the firm. In other words, an independent director ought to have no substantive business affiliation with the firm and its key stakeholders that spans beyond the directorship position. For example, a financier, a supplier, a customer, or other affiliated directors (also called gray directors) are nonindependent directors because they have a significant stake in the affairs of the corporation.

The independent directorship position is believed to be intrinsically conducive to rational decision-making during key boardroom deliberations. In turn, a rational decision-making process would logically diminish the agency costs of the firm. Ultimately, a reduction in agency cost would steer the corporation in the right direction. In many respects, the argument in favor of boardroom independence bears similarities with Darwinian's logic (Millstein & MacAvoy, 1998). Ceteris paribus, boardroom independence is akin the minute grain that decisively tilts the balance in favor of superior corporate performance. The independent directorship position also bears other economic benefits. By virtue of its detached status from the management team, the independent directorship position would induce the CEO and the rest of the management team to seek out different and, perhaps, more creative solutions to corporate problems. Equally important, the independent directors may play an important role in co-opting influential external constituencies, in securing networking opportunities (such as strategic alliances), and in projecting a sense of corporate credibility and legitimacy to the external world.

3. The economic value of boardroom independence: a survey of the literature

Proposition 1: An Independent boardroom adds economic value. Being firmly grounded in agency theory, boardroom independence is expected to be correlated with corporate performance. A large stream of studies indeed postulates that a positive correlation exists between percent outside directors and corporate performance (e.g., Liu, Miletkov, Wei, & Yang, 2015; Baysinger & Butler, 1985; Schellenger, Wood, & Tashakori, 1989; Pearce and Zahra, 1992; Ezzamel & Watson, 1993; Rosenstein and Wyatt, 1990). Accordingly, a firm ought to increase the percentage of its independent directors while curtailing the percentage of inside directors in its boardroom. Notably, Rebeiz and Salameh (2006) provided empirical evidence that a critical mass of independent directors translate into superior financial market returns for the firms belonging to the construction industry. Furthermore, Liu et al. (2015) indicated that independent directors have an overall positive effect on firm operating performance in China. In a different, yet closely related concept, it has been reported that firms with strong shareholder rights economically outperform firms with weak shareholder rights (Gompers, Ishii, & Metrick, 2003).

Proposition 2: An Independent boardroom destroys economic value. This perspective implicitly suggests that the inside directorship position is economically advantageous to the firm because the inside directors, being the executives of the firm in which they assume the directorship position, are the ultimate organizational experts. In other words, the informed insiders are in a better position to make important corporate governance decisions than the uninformed outsiders. Consequently, a boardroom with a preponderance of inside directors would create economic value. Conversely, a boardroom with a predominance of outside directors would destroy economic value. In other words, a positive correlation would exist between percent inside directors and corporate performance, whereas a negative correlation would exist between percent outside directors and corporate performance. This proposition has received many favorable echoes in the prevailing corporate governance literature (e.g., Coles, McWilliams, & Sen, 2001; Kesner, 1987).

Proposition 3—The uncertain economic proposition of an independent boardroom: A large body of literature postulates that no systematic relationship exists between the independence composition and the corporate performance (e.g., Volonté, 2015; de Andrés, Azofra, & Lopez, 2005; Dulewicz & Herbert, 2004; Dalton,

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