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Board independence and firm performance: The moderating effect of institutional context

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ABSTRACT

This study proposes a new research approach to examine the relationship between board independence and corporate performance, measured by technical efficiency. Moreover, this paper examines the moderating role that institutional factors exert on this relationship through the legal system—the content of law and its enforcement. The research questions are examined using an international sample of 2185 firms from 2006 to 2015, applying truncated regression models for panel data and employing data envelopment analysis to examine efficiency as a measure of performance. This paper supports that board independence increases the firm's technical efficiency. Even more, greater legal and judicial protection exerts a positive moderating effect on the previous relationship by protecting private benefits for insiders, among other aspects. Thus, the positive impact of independent directors on efficiency is greater when firms operate in countries with a greater extent of law and enforcement. Our findings include endogeneity checks using instrumental variables.

1. Introduction

The separation between ownership and control brings with it a potential divergence of interests between shareholders and managers, the latter potentially adopting opportunistic behaviours to benefit their wealth, power and status. In this regard, corporate governance can be viewed as a control mechanism safeguarding the interests of shareholders (García-Sánchez, Rodríguez-Domínguez, & Frías-Aceituno, 2015; Kang, Cheng, & Gray, 2007). Among corporate governance tools, the board of directors is considered the central axis, key in generating and preserving investor confidence, providing better access to financing, reducing agency costs and thus improving the efficiency of the organizational structure (Berle & Means, 1932; Fama & Jensen, 1983; García-Sánchez & Martínez-Ferrero, 2017; Jensen & Meckling, 1976; Shleifer & Vishny, 1997).

In recent years, financial and accounting fraud, alongside bankruptcies in large companies, has led to a higher level of research on the ideal composition of the board as a mechanism for monitoring and supervising management, and its impact on business performance (Leung, Richardson, & Jaggi, 2014; Liu, Miletkov, Wei, & Yang, 2015; Terjesen, Couto, & Francisco, 2016; Zelenyuk & Zheka, 2006). In this respect, a great many empirical studies have associated boards of directors with business results. The latter have been measured by accounting ratios or by market variables such as Tobin's Q (Bhagat & Black, 2002; Campbell & Mínguez-Vera, 2008; Pletzer, Nikolova, Kedzior, & Voelpel, 2015; Rose, 2007). However, an interest in using technical efficiency as a measure of performance has recently been generated, based, on the one hand, on the fact that the transformation process is the core of business activity (Liu et al., 2015; Sheu & Yang, 2005; Terjesen et al., 2016) and, on the other hand, on the fact that this measure has a series of attributes and advantages (discussed later) that make it much more appropriate than traditional measures.

Examining board composition as a factor of firm performance, it appears that independence of this internal control mechanism, in the form of non-executive directors, guarantees the success of its functioning. However, there is no consensus regarding the relationship between independent directors and performance. Some studies have argued that the non-effectiveness of board independence, the complexity of the firm and limited information reduce firm performance (Agrawal & Knoeber, 1996; Bhagat & Black, 2002; Cavaco, Crifo, Rebérioux, & Roudaut, 2017; Cho & Kim, 2007; De Andres, Azofra, & Lopez, 2005; Haniffa & Hudaib, 2006; Terjesen et al., 2016). Nonetheless, several studies (Aggarwal, Erel, Stulz, & Williamson, 2010; Baysinger & Butler, 1985; Dahya, Dimitrov, & McConnell, 2008; Leung et al., 2014; Luan & Tang, 2007; Zhu, Ye, Tucker, & Kam, 2016) have demonstrated a positive relationship between board independence and efficiency as a measure of performance (Bozec & Dia, 2007; Hsu & Petchsakulwong, 2010; Liu et al., 2015; Tanna, Pasiouras, & Nnadi, 2011). Due to the

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absence of generalizable results, this paper will examine the relationship between board independence and firm performance to clarify the proposed impact.

This paper thus examines the relationship between board independence and efficiency, recognizing that the institutional context, represented by the legal system, can moderate this relationship. But how? This is due to the role played by the institutional environment in the behaviour of directors, thus affecting corporate performance. Differences in the environment transcend companies and their boards of directors (Denis & McConnell, 2003; Organization for Economic Cooperation and Development [OECD], 2017). In this respect, several studies assert that the legal origin of a country influences the effectiveness of the board of directors, the deterrence of opportunistic and inefficient management behaviours, and financial results (Defond & Hung, 2004; Kim, Kitsabunnarat-Chatjuthamard, & Nofsinger, 2007; Klapper & Love, 2004; La Porta, Lopez-de-Silanes, & Shleifer, 2006; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000, 2002). The stricter the legal and judicial mechanisms in place, the greater the likelihood that unethical practices will be detected by the market and that independent directors will have to bear additional costs arising from the impact of such practices on their professional reputation, and hence the possibility of their occupying similar positions in other companies.

Thus, in order to test the moderating role of the legal system in the impact of board independence on firm performance, we use a sample of 2185 international companies with data for the period 2006–2015. Technical efficiency is proposed as a performance measure determined using data envelopment analysis (DEA) and applying resampling methods and bootstrapping techniques in line with Simar and Wilson (1998). Board independence is represented by Blau's (1977) index. Truncated regressions, according to algorithm (1) proposed by Simar and Wilson (2007), are used to determine the relationship between board independence and efficiency, and the moderating effect of the content of law and enforcement. In addition, sensitive analysis is carried out to ensure the robustness of the findings by considering the possibility that the board independence variable is endogenous, for which regressions with instrumental variables (2SLS) are used.

The remainder of the paper is structured as follows. The following section summarizes the theoretical framework related to use of the efficiency concept as a measure of firm performance, the board of directors as an internal control mechanism—focusing on board independence—and, finally, the institutional context underpinning the proposed hypothesis. The subsequent section describes the research model, data and sample. The penultimate section presents the empirical results and a discussion of the findings, while the main conclusions are addressed in the final section.

2. Efficiency, board of directors and institutional context: research hypotheses

2.1. Efficiency as a measure of corporate performance and the board of directors

In recent years, the globalization of markets and an increase in business competitiveness have generated an uncertain economic environment, characterized by lower business survival. In this context, analysis of business performance is of great interest to academics and practitioners as it allows identification of negative patterns of behaviour in order to correct them and to improve the performance of a company.

Among the wide range of representative measures of firm performance, business profitability (measured by accounting ratios or market variables, such as Tobin's Q) and technical efficiency are the parameters most often used (Bhagat & Black, 2002; Campbell & Mínguez-Vera, 2008; García-Meca, García-Sánchez, & Martínez-Ferrero, 2015; Liu et al., 2015; Pletzer et al., 2015; Rose, 2007; Terjesen et al., 2016). However, technical efficiency can be considered a better estimator of business performance, as the central axis of a company is its productive process. Thus, technical efficiency reveals the information needed to know how well things are being done (Sheu & Yang, 2005). In contrast, Tobin's Q, a measure that reflects the psychology of investors and the stock market, turns out to be very volatile. Also, incorporating disaggregated information from individual observations—for example, one day—does not allow a general evaluation of the results as a whole—for example, one year (Sheu & Yang, 2005). In countries with underdeveloped capital markets and with a very small number of firms, it is very difficult to make a market assessment because the information is limited; there is high variance of prices, resulting in less reliable forecasts, and this is reflected in Tobin's Q (Destefanis & Sena, 2007).

What is more, measures of profitability include information that starts from management decisions about when a good is depreciated and therefore the point at which new investment (investment myopia) is needed, while technical efficiency focuses on the productive process and does not contain this bias (Destefanis & Sena, 2007).

In short, technical efficiency is considered by some authors as less ambiguous than financial measures (Hill & Snell, 1989), the latter being extremely sensitive to differences in accounting methods or accounting manipulation of profits (García-Sánchez, 2010). Sometimes management is interested in participating in projects which, while they do not add value, enhance management, in which case technical efficiency is immediately affected (Destefanis & Sena, 2007). In addition, the efficiency measure captures the agency costs of the division between ownership and control. Finally, several studies mentioned by Sheu and Yang (2005) reveal that when calculating technical efficiency—and given the correlations—it is possible to determine the levels of and changes in productivity, profitability and share price. In this respect, Lehmann, Warning, and Weigand (2004) find that efficiency indices contribute significantly to explaining differences in profitability between firms.

In focusing on the concept of technical efficiency, it is necessary to consider the relationship between input and output, understood respectively as the factors of production used in a transformation process and the goods and/or services that are obtained as a result. Thus, efficiency (or technical efficiency) can be understood as the possibility of obtaining the maximum quantity of output with the same level of input, or maintaining a given level of output while minimizing the quantity of input. Production theory (Cobb & Douglas, 1928; Dillard, 1980) is based on the production function, understood as the mathematical representation that shows the greatest quantity of output that a company can produce from the quantity of input used (Seiford & Thrall, 1990).

This study focuses on examining the factors that affect this level of firm performance by using technical efficiency as a proxy. Among these, the board of directors provides the structure through which the company's goals are set, along with determining the means to achieve those objectives and promote performance monitoring; it promotes the efficient use of resources and, equally, demands to be held accountable for the administration of those resources (OECD, 2017).

In this regard, different theoretical approaches can be adopted when considering the role and influence of boards of directors. The great majority of studies adopt agency theory, which addresses the divergence of interests between shareholders and managers, with the board of directors mainly adopting a controlling role over managers. According to the agency perspective (the dominant framework), as one of the most important governance mechanisms, boards play a pivotal role in monitoring managers to reduce problems associated with the separation of ownership and control in public corporations (Fama & Jensen, 1983). The strategic role of boards has become increasingly important, going beyond the mere approval of strategic management decisions (Chen, Cheng, & Wang, 2015; Cuadrado-Ballesteros, Rodríguez-Ariza, & García-Sánchez, 2015; García-Sánchez & Martínez-Ferrero, 2017; Kim, Burns, & Prescott, 2009). The board must serve to reconcile management decisions with the objectives of shareholders and stakeholders, which can at times influence strategic decisions.

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