Journal of Financial Economics 113 (2014) 383–403

Contents lists available at ScienceDirect

Journal of Financial Economics

journal homepage: www.elsevier.com/locate/jfec

Do independent directors cause improvements in firm transparency?☆

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ARTICLE INFO

Article history:
Received 23 August 2012
Received in revised form
14 August 2013
Accepted 8 December 2013
Available online 27 May 2014

JEL classification:
G34
G38
K22

Keywords:
Corporate governance
Board of directors
Corporate transparency
Information asymmetry
Board regulations

ABSTRACT

Although recent research documents a positive relation between corporate transparency and the proportion of independent directors, the direction of causality is unclear. We examine a regulatory shock that substantially increased board independence for some firms, and find that information asymmetry, and to some extent management disclosure and financial intermediation, changed at firms affected by this shock. We also examine whether these effects vary as a function of management entrenchment, information processing costs, and required changes to audit committee independence. Our results suggest that firms can alter their corporate transparency to suit the informational demands of a particular board structure.

1. Introduction

We examine whether firm transparency improves in response to an increase in the proportion of independent directors. Independent directors, as outsiders to the firm, must acquire and process a substantial amount of firm-specific information to effectively perform their advising and monitoring duties. When the corporate information environment is opaque, and there are significant costs to acquire and process detailed information about their firm's operating, financing, and investing activities, independent directors are less effective. Further, management has a fiduciary responsibility to keep both independent directors and shareholders informed about the firm's activities and management's performance, and this transparency can be impaired when boards are dominated by insiders. We document that corporate transparency, as measured by proxies for information asymmetry, disclosure, and information intermediation, generally improves following a required increase in the proportion of independent directors. We also examine the lead/lag relation between changes in board structure and changes in corporate transparency, as well as whether these effects vary as a function of management entrenchment, information

☆ We appreciate the comments of an anonymous referee, Tim Baldenius, Mary Billings, Liz Chuk, Vivian Fang, Yaniv Grinstein, Michelle Hanlon, Jon Kalodimos, Andy Leone, Christian Leuz, David Maber, Dawn Matsumoto, Mike Minnis, Valeri Nikolaev, Peter Pope, Jonathan Rogers, Rodrigo Verdi, Sarah Zechman, and workshop participants at London Business School, MIT Sloan, New York University, Northwestern University, the University of Chicago, the University of Southern California, and the University of Washington, and gratefully acknowledge the financial support of MIT Sloan and of the Wharton School.

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http://dx.doi.org/10.1016/j.jfineco.2014.05.009

processing costs, and required changes to audit committee independence. When interpreted in the context of existing literature, our results highlight simultaneity in the evolution of board structure and corporate transparency, and suggest that transparency can be altered to suit the informational demands of a particular board structure.

A growing literature documents that a firm's information asymmetry and transparency influence attributes of its board structure in general, and the degree of independence in particular. This literature argues that independent directors have difficulty performing their advising and monitoring roles when information asymmetry and information transfer and processing costs are high, and therefore, that firms with high information asymmetry choose to have relatively few independent directors (e.g., Linck, Netter, and Yang, 2008; Lehn, Patro, and Zhao, 2008). Consistent with this prediction, several recent papers find a negative relation between board independence and both information asymmetry and information transfer costs.[1] These papers, however, generally assume that corporate transparency is exogenous with respect to board structure. That is, these studies do not consider that managers and directors may be able to lower information transfer costs by committing to various financial reporting and disclosure policies.[2] If corporate transparency is endogenous in this way, then the interpretation of a negative relation between information asymmetry and board independence becomes more complicated (and may stem from board structure influencing information asymmetry as well as information asymmetry influencing board structure).

The notion that a firm's board structure, including its proportion of independent directors, can influence various aspects of corporate transparency is not new, at least within the literature on financial reporting and disclosure. For example, Petra (2007) and Ferreira, Ferreira, and Raposo (2011) document positive relations between the proportion of independent directors and accounting quality and earnings informativeness, respectively. Similarly, Beekes, Pope, and Young (2004) and Ahmed and Duellman (2007) find that timely recognition of losses (a commonly used measure of earnings quality) is greater for firms with a higher proportion of independent directors.[3] These authors generally interpret these results as being consistent with independent directors improving the quality of financial reporting, although as we note in Section 2, these papers generally do not provide evidence on the causality of this relation.

These two literatures suggest different directions of causality in the relation between board structure and corporate transparency. One literature argues that corporate transparency and information transfer and processing costs are primarily exogenous, and are dictated by firm characteristics such as size, growth opportunities, and business environment uncertainty. As such, board independence is, in part, a function of these exogenous firm characteristics. The other literature argues that independent directors can take actions to increase their firm's transparency because lower information asymmetry can aid independent directors in reducing agency conflicts that arise from managers' informational advantage. A variant of this argument is that managers commit to more transparent financial reporting and disclosure practices to attract independent directors, and to make those directors more effective.[4] Thus, these competing, non-mutually exclusive, arguments leave open the question of whether corporate transparency is an exogenous determinant of board structure, or instead whether independent directors (or managers, or even regulators) can actively induce changes in corporate transparency, thereby altering the efficacy of certain board structures.

To provide more definitive evidence of whether firms' information environments adapt to fit the informational needs of a particular board structure, we examine a shock to the proportion of independent directors, and then observe whether and how these firms' information environments change in response to this shock. Similar to Duchin, Matsusaka, and Ozbas (2010), we use regulations issued in 2003 by the NYSE and Nasdaq as an exogenous event that significantly altered the proportion of independent directors of some firms' boards.[5] These regulations required most listed corporations to have a majority (more than 50%) of independent directors on their boards. In general, firms were required to comply with these regulations by the earlier of: (1) the listed firm's first annual shareholder meeting after January 15, 2004; or (2) October 31, 2004. Some firms already had a majority of independent directors on their boards and therefore complied with these new regulations at the time they were issued; other firms did not. In our sample, the firms that were not in compliance with the majority board independence rule (as of 2000) have a 45% increase in the mean proportion of independent directors, whereas firms that were already in compliance experienced virtually no change in their proportion of independent directors during the same period.

[1] See, for example, Boone, Field, Karpoff, and Raheja (2007), Coles, Daniel, and Naveen (2007), Linck, Netter, and Yang (2008), Lehn, Patro, and Zhao (2008), Cai, Liu, and Qian (2009), and Ferreira, Ferreira, and Raposo (2011).

[2] Ferreira, Ferreira, and Raposo (2011) examine how stock price informativeness affects board independence. As a sensitivity analysis, they consider the possibility that price informativeness and board structure might be jointly determined, and estimate two- and three-stage least squares regressions to ensure that their results are robust to controlling for potential reverse causality. The focus of this analysis, however, is on controlling for the reverse causality effect, as opposed to exploring its existence and characteristics.

[3] In a related vein, Klein (2002) and Krishnan (2005) find that the proportion of independent audit committee directors is negatively related to the magnitude of discretionary accruals and the incidence of internal control weaknesses, respectively. Goh, Ng, and Yong (2011) examine the cross-sectional association between board independence, accruals quality, management forecasts, analyst coverage, and information asymmetry. They address the endogeneity of board independence by using board connections, which they define as "the fraction of dependent directors with board connections to boards with a majority of independent directors" as an instrumental variable.

[4] See Engel (2005) for a similar argument in the context of firms committing to high quality financial reporting to attract financial experts to the audit committee of the board of directors.

[5] Duchin, Matsusaka, and Ozbas (2010) use the 2002 Sarbanes-Oxley (SOX) regulation related to audit committee independence.