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Board independence, investment opportunity set and performance of South African firms☆

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ABSTRACT

This study examines the association of firm performance and board independence, in concert with growth options for South African firms. It is motivated by the recent reform of the King regime of corporate governance, King III, in 2010. Archival data for firms listed on the Johannesburg Stock Exchange in both the pre-King III (2008–2009) and post-King III (2011–2012) eras are used. Cross-sectional levels and difference analyses are employed to determine whether change in board independence conjoint with growth status has a performance effect for firms. Transition from pre-to post-King III has had a positive impact on the relationship of independent non-executive directorship jointly with growth potential for firms' performance. The current study implies board independence is important. It is relevant for the attraction of foreign investment in economies such as those in the Asia-Pacific, worthy of stressing by corporate regulators and of cognizance by investors. Prior studies relating board independence to firm performance have had mixed and compromised results. This study overcomes limitations of earlier literature and addresses a key feature of corporate governance reform in a developing country.

1. Introduction

Corporate governance has drawn attention dating back to the work of Berle and Means (1932) on the separation of ownership and control typical for modern corporations. This field has, more recently, received extensive research interest, including from the accounting and finance disciplines (Brown et al., 2011) due to

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practitioners' and theorists' perception of it as a fundamental factor in firms' performance. Sound corporate governance practices such as the monitoring of managers and the incentives provided to them are perceived as essential to aligning their actions with the interests of claim holders and being typically positive for firm value (Bhagat and Bolton, 2008). Shortcomings in corporate governance have been proposed as factors in the 'Asian Financial Crisis' of 1997–98 (Wolfensohn, 1998). Similar limitations likely underlie the 'short-termism' characteristic of 'financialization', a suggested precursor to the 'Great Contraction' ongoing from 2007 (Reinhart and Rogoff, 2009).

A definition of corporate governance is that it is the set of mechanisms which evolved to mitigate the impact of the separation of the management and financing of business entities (Shleifer and Vishny, 1997; Larcker et al., 2007). Researchers often categorize corporate governance into internal (e.g. board characteristics) and external (e.g. the market for corporate control) forms (Gillan, 2006; Brown and Caylor, 2006; Cremers and Nair, 2005). A fundamental proposition in corporate governance is that the board of directors should be independent of the management of the company (Hermanson, 2003). Theorists have argued for board independence (BI) enabling boards to be most effective in monitoring senior management (Fama and Jensen, 1983a).

This study's motivation is twofold. The first motivation is the lacuna in the literature on the impact of BI on firms' financial performance (FP) in developing countries. South Africa has been a regional leader in that it has introduced and refined a code of corporate governance (King Reports I, II, and III) during and subsequent to the country's recent political and economic transition. Vaughn and Ryan (2006) suggest that, given South Africa's corporate governance advances, it can serve as a bellwether in this respect for the entire African continent. And, in fact, other African nations are already modeling their corporate governance codes on the King regime (Rossouw, 2005). A likely key incentive is its attractiveness to foreign direct investment (FDI), argued as essential for the viability and growth of emerging economies (Nenova, 2004). The current study casts light on the potential for South Africa's corporate governance framework, via the central issue of reformed board independence, to serve as an exemplar for not only other African countries but developing countries more widely, such as those of the Asia-Pacific seeking to improve capital market functioning, including improved ability to attract FDI. The second motivation for this study is the prospect of reducing uncertainty concerning the impact of BI on FP. The extant literature is characterized by inconsistent findings and the likely unreliability of direct measures of BI impacts on FP due to endogeneity.

This study models FP in relation to BI measures using data on 151 non-financial firms listed on the Johannesburg Stock Exchange (JSE) in the financial reporting years ending in 2008–2009 and in 2011–2012, bracketing the implementation in 2010 of the King Report III (King III). The investment opportunity set (IOS), an essentially exogenous economic condition, is invoked to handle the endogeneity issue. Estimation of the cross-section relations of levels of firms' FP with BI-IOS interactions is implemented in pooled and pre- and post-King III formats. This analysis allows comparison of the pre- and post-2010 policy regimes. Difference analyses are adopted to exploit the repeated cross-sectional data, allowing an analysis of the FP impact of changes in the BI-IOS interactions. BI is measured as the proportion of independent non-executive directors on the board, the board chair's executive status, and executive directors' share ownership. The financial performance measure adopted is return on equity (ROE). The IOS proxy used is market-to-book value of equity (MBVE).

The cross-section levels analysis suggests that independent non-executive directorship on company boards has a synergistic effect with companies' IOS such that FP is positively related in the post-King III era. In other words, under the revised governance regime, independence of the board as reflected in independent non-executive directorship is important for growth firms' financial performance. The difference analyses of repeated cross-sections confirm that substantial, joint increases in independent non-executive directorship and growth potential positively impact FP.

This study contributes to the quite limited extant research on the firm performance impact of a change in corporate governance regime. In fact it appears to be the first study to consider change in corporate governance regimes in developing countries. This study focuses on the effect of King III on the monitoring costs of the corporate board and examines the impact of King III on the association between BI and FP via the investment opportunity set. Moreover, this study has implications for the growing controversy over mandating of strict definitions for and the preponderance of 'independent' non-executive directorship on corporate boards.

From this point the paper proceeds as follows. Section 2 outlines the South African institutional context while Section 3 considers corporate governance theory and reviews the empirical literature on the association of board independence and financial performance and the evidence for, and potential of, investment options to condition such a relationship, advancing a proposition to be tested on this key issue. The research approach,