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Globalizing the boardroom—The effects of foreign directors on corporate governance and firm performance ☆

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ABSTRACT

We examine the benefits and costs associated with foreign independent directors (FIDs) at U.S. corporations. We find that firms with FIDs make better cross-border acquisitions when the targets are from the home regions of FIDs. However, FIDs also display poor board meeting attendance records and are associated with a greater likelihood of intentional financial misreporting, higher CEO compensation, and a lower sensitivity of CEO turnover to performance. Finally, firms with FIDs exhibit significantly poorer performance, especially as their business presence in the FID's home region becomes less important.

1. Introduction

The board of directors is a critical element in a firm's corporate governance system, and it has two major functions. One is to hire, fire, and compensate managers, i.e., the monitoring role, and the other is to advise managers on important strategic decisions, i.e., the advisory role. How well directors perform these two functions largely determines the effectiveness of boards in corporate decision making and shareholder value creation.[1]

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[1] Early studies on corporate boards focus primarily on their monitoring function (see the survey by Hermalin and Weisbach, 2003), while recent literature recognizes their dual roles of monitoring and advising. Boards often perform these roles simultaneously (Brickley and Zimmerman, 2010).

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In this study, we focus on an interesting class of directors whose unique characteristics can either enhance board decision making or weaken it. Specifically, we examine foreign independent directors (FIDs) in U.S. corporations, defined as independent directors domiciled in foreign countries.[2] The geographic location of FIDs is a double-edged sword. As we elaborate below, FIDs can provide valuable international expertise and advice to firms, especially those with significant foreign operations or plans for overseas expansion. On the other hand, foreign independent directors are apt to be less effective in overseeing management than U.S.-based independent directors and thus, they could weaken a board's monitoring and disciplining role.

Foreign directors can be less effective monitors for several reasons. First, a director's geographic distance from corporate headquarters generates substantial oversight costs, since making on-site visits and attending board meetings (usually held at corporate headquarters) become more difficult and time-consuming. This undermines a director's ability and incentives to gather information and closely monitor management. Consistent with this view, Lerner (1995) finds that venture capitalists are reluctant to sit on boards of geographically distant firms, and Knyazeva, Knyazeva and Masulis (2011) document a significant local component to the matching process of companies and outside director candidates. The obstacles created by distance are even greater for FIDs, as the time zone differences and time and energy consumed by international travel, coupled with heightened security concerns post 9/11, are likely to impose heavier burdens on foreign directors than on domestic directors, further eroding their monitoring incentives and ability.[3] Second, directors who are geographically removed from the vicinity of a firm's corporate headquarters are cut off from local networks that provide valuable soft information (Coval and Moskowitz, 1999, 2001). Located in foreign countries, FIDs have even fewer channels and less access to current information about the U.S. companies on whose boards they sit, and thus may be less able to stay well informed about these firms' current operations and performance. Third, FIDs are likely to be less familiar with U.S. accounting rules, laws and regulations, governance standards, and management methods, making it more difficult for them to evaluate managerial performance or challenge managerial decisions. These considerations suggest that FIDs can often weaken a board's monitoring effectiveness, and thus lead to greater agency problems between managers and shareholders and ultimately poorer firm performance.

Concerns about the incentives and ability of FIDs to oversee management are consistent with several anecdotes. Before Sir Win Bischoff stepped down as Citigroup's chairman in February 2009, some Citigroup directors were considering replacing him as chairman, because "*Sir Win, who is based in London, hasn't been exercising adequate oversight*."[4] During the period of 1997–2001 when Enron committed high profile accounting fraud, its audit committee included two foreign independent directors, the Chairman of the Hang Lung Group in Hong Kong and a senior executive of Group Bozano in Brazil, which raises questions about the effectiveness of FIDs' monitoring of a firm's operations and financial reporting. Concerns with FIDs are not unique to U.S. firms. The Korean Corporate Governance Service highlighted the poor board meeting attendance record of foreign outside directors of Korean companies over the 2004–2006 period and suggested that "*the main reason behind foreigners' low attendance is that most of them live outside Korea and are unable to fit traveling here for the meeting on their schedule*."[5]

Despite their monitoring deficiencies, FIDs can enhance the advisory capability of boards to the extent that living or working in foreign countries gives them first-hand knowledge of foreign markets and enables them to develop and tap a network of foreign contacts. These resources can enable FIDs to provide valuable advice and assistance to U.S. corporations, especially those with major foreign operations or aspirations to expand internationally (Adams et al., 2010).[6] As companies make initial forays into particular foreign markets or try to expand their foreign operations, they face unfamiliar political landscapes, regulatory environments, cultural and social norms, industry structures, and consumer preferences. For these companies, FIDs' knowledge of their home countries or regions and their close connections to local business, social, and political circles can be beneficial.[7]

Given the concomitant benefits and costs associated with FIDs, their net effect on overall board effectiveness, corporate decision making, and firm performance represents an intriguing empirical question. Our investigation focuses on the following issues: How prevalent are FIDs on the boards of U.S. public companies? Which firms are more likely to have FIDs? Are FIDs less effective monitors than their U.S. based counterparts? Under what circumstances do companies benefit

(*footnote continued*)
Adams and Ferreira (2007) and Harris and Raviv (2008) develop theories of boards based on their dual functions. Boone et al. (2007), Coles et al. (2008), Linck et al. (2008), and Lehn et al. (2009) empirically show that board structure is shaped by the heterogeneity in firms' demands for monitoring and advising. Faleye et al. (2011a, b) examine the potential tradeoff between director monitoring and advising and find evidence indicative of significant costs from intense board monitoring and benefits associated with advisory directors on boards.

[2] In our definition, FIDs do not have to be foreign nationals and they can be U.S. citizens working or living in a foreign country, while a foreign national working or living in the U.S. will not qualify as a FID.

[3] In an interview with *The Financial Times*, Charles King, a managing director of Korn Ferry International (an executive search firm), comments on the logistical problem of hiring a foreign director–"To get someone to fly to New York for a board meeting six or seven times a year, even from London, takes at least 18 days out of their schedule." The same concern is also voiced by some companies mentioned in the aforementioned *WSJ* article.

[4] David Enrich and Robin Sidel, "Citi Directors Mull Replacing Chairman", *The Wall Street Journal*, November 13, 2008.

[5] Hyong-Yi Park, "Foreign Outside Directors' Presence at Board Meetings Low", *The Korea Times*, August 13, 2007.

[6] This would be consistent with Agrawal and Knoeber's (2001) finding that firms for which politics and regulations are more important are more likely to have outside directors with political and legal background.

[7] See for example, Joann S. Lublin, "Globalizing the boardroom", *The Wall Street Journal*, October 31, 2005.