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Board reforms and firm value: Worldwide evidence☆

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ABSTRACT

We examine the impact of corporate board reforms on firm value in 41 countries. Using a difference-in-differences design, we find that board reforms increase firm value. Reforms involving board and audit committee independence, but not reforms involving separation of chairman and chief executive officer positions, drive the valuation increases. In addition, while comply-or-explain reforms result in a greater increase in firm value than rule-based reforms, the effects of reforms are similar across civil law and common law countries. Further investigation shows that the subsequent change in board independence plays an important role in explaining the effectiveness of the reforms.

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1. Introduction

The last two decades witnessed a worldwide explosion of corporate board reforms designed to increase firm value by imposing or recommending greater board independence, audit committee and auditor independence, and separation of the chairman and chief executive officer (CEO) positions. In addition to receiving considerable attention by investors and regulators, these reforms are the focus of a growing body of research because they allow a shock-based research design that mitigates the endogeneity concerns inherent in examining cross-sectional relations between board composition and performance. Existing research, however, typically focuses on a single country and yields mixed results.[1] Thus, several important but unanswered questions arise: How do the board reforms affect firm value? Does institutional quality affect the success of board reforms? Does the approach taken to adopt reforms matter? If so, how? In this paper, we address these questions by assessing the impact of major corporate board reforms on firm value around the world.

We focus on governance reforms related to board practices because boards are the fundamental governance mechanism of corporations and because board reforms are

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[1] While some studies find that these reforms increase firm value in India, South Korea, and the UK (Black and Khanna, 2007; Black and Kim, 2012; Dahya and McConnell, 2007, respectively), other studies find that these reforms reduce firm value in the US (Zhang, 2007; Li, 2014). See Atanasov and Black (2016) for further discussion on using shock-based methods to draw causal inferences.

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the major approach to address corporate governance issues.[2] The common emphasis of board reforms is outside representation on the board. The notion is that greater oversight by outside board members discourages corporate insiders (such as top executives and controlling shareholders) from extracting private benefits and overconsuming perks and encourages them to invest in projects that benefit all shareholders and to improve financial reporting transparency. In turn, outsiders' willingness to finance the firm should increase, thereby reducing the cost of capital and enhancing firm value. Reforms can be necessary because important frictions prevent firms from investing in good board practices that can increase shareholder value. Corporate insiders might not have incentives to invest in strong board practices as desired by the minority shareholders because they bear the full cost of losing private benefits but reap only part of the benefits from increased firm value. Board reforms enacted by the government can help overcome this friction by requiring firms to make the investment to improve board practices regardless of their controlling shareholders' view. Consequently, board reforms are justified because they require or encourage firms to have board attributes that they would not otherwise adopt.

Some critics of board reforms, however, argue that existing board practices are the equilibrium outcome of a market solution and, therefore, reflect the firm's optimal choice after taking all factors into consideration. Thus, board reforms that push firms away from this arrangement could be unnecessary and potentially harmful. In addition, some argue that firms can appoint directors who appear to be independent but are, in fact, cronies of managers. Yet others argue that having independent directors can be harmful. Such directors can be overly conservative and constrain a firm's growth because they are not as familiar with companies' operations as their reputation and compensation depend less on earnings growth and profitability. Thus, the average effect of board reforms on firm value is an empirical question.

Our empirical analysis examines a set of major board reforms in 41 countries between 1990 and 2012. Using a difference-in-differences (DID) design that includes firm and year fixed effects, we find that on average firm value increases following the reforms. We use several approaches to mitigate potential concerns regarding our DID estimation. First, to mitigate the concern of confounding events and correlated omitted variables, we test the effect of board reforms on firm value using five years before and after the reform. In addition, we control for the effects of insider trading enforcement and takeover reforms, dividend and capital gains taxes for shareholders, and various other time-varying country-level, firm-level, and industry-level variables. Second, we examine the years surrounding the reforms separately to address the concern that reforms could be passed in response to changing economic conditions. We find that the increase in firm value materializes on or after the board reforms become effective in the country. In addition, no evidence indicates an increasing or decreasing trend in firm value prior to the reforms, suggesting that the reforms in general are likely actions taken by countries when they realize the importance of governance and not so much a drastic response to economic difficulties or scandals. Third, to assess the validity of the parallel trend assumption underlying the DID design, we conduct two tests using pseudo reform years during both the pre- and post-reform periods. We find no evidence of changes in firm value subsequent to the pseudo reform years. Fourth, we use alternative DID specifications by restricting our sample period to begin in 2000 and benchmarking with propensity score matched (PSM) firms in the UK, the major country passing board reforms before 2000. We again find our results remain qualitatively similar.

Next, we examine the effect of major components of reforms. Our analyses suggest that reforms involving board and audit committee independence, but not those involving separation of chairman and CEO positions, lead to improvements in firm value. We also find that our inferences remain unchanged after further controlling for the effect of concurrent non-board governance reforms. In an important additional test, we find that firms more likely impacted by reforms involving board independence (i.e., firms without majority board independence in the pre-reform period) have greater increases in value subsequent to these reforms, thereby further bolstering the validity of our inferences.

We also evaluate the role of initial country-level conditions and reform approaches. We examine the role of legal origin. The law and finance literature (e.g. La Porta, Lopez-de-Silanes, Shleifer, and Vishny, 1997, 1998), suggests that a country's legal origin is an important factor explaining its investor protection and capital market development. Somewhat surprisingly, the effects of reforms are similar in civil law and common law countries. Second, we examine the role of reform approaches. Some reforms such as the UK Cadbury Report (formally, *Financial Aspects of Corporate Governance*, assigned by the committee on the Financial Aspects of Corporate Governance, chaired by Adrian Cadbury) adopt a comply-or-explain approach in which firms can choose to explain why they do not comply, but other reforms such as the US Sarbanes–Oxley Act of 2002 (SOX) use a rule-based approach that makes compliance mandatory. While the one-size-fits-all rule-based reforms run the risk of becoming overregulation, comply-or-explain codes might not have enough teeth because they are basically suggestions.[3] Thus, the effectiveness of different reform approaches is an empirical question. Our results indicate that comply-or-explain reforms are associated with a greater increase in firm value than rule-based reforms.

[2] Having a corporate board is a legal requirement for incorporation, and the role of corporate boards in mitigating agency conflicts and protecting shareholder interests has long been recognized in the literature. Hermalin and Weisbach (2003) and Denis and McConnell (2003) review the studies on US boards and non-US boards, respectively.

[3] However, codes carry the threat that more regulations will follow if firms do not comply without a clear explanation (Dahya, McConnell, and Travlos, 2002). For example, the Cadbury Report (Section 1.1) explicitly acknowledges that legislation would very likely follow if companies that do not comply with the guidelines cannot provide a convincing explanation.

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