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ROLE OF INDEPENDENT DIRECTORS IN THE VALUE ENHANCEMENT OF EQUITY SHAREHOLDERS: A LITERATURE REVIEW

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ABSTRACT

The relationship between independent directors and firm's value has been a more controversial issue of academic research in corporate governance literature. Several empirical studies that examine such relationship pinpoints to the effects of different facets of independent directors such as number, proportion, background, characteristics on the firm's financial performance. In fact, there is no clear-cut answer to this debatable issue because the results of empirical studies on whether the independent directors can improve corporate governance and shareholders' value are mixed. Generally, there are three types of empirical results in regard to the correlation between independent directors and firm's financial performance and shareholders' value, which are either positive or negative or no relation exists between them. In this paper we have attempted a brief literature survey on the role of independent directors on shareholders' value enhancement.

Keywords: *Corporate Governance, Firm Value, Tobin's Q, Stakeholders, Interlocking Independent Directors, Shareholders' Value, Wealth Maximization, Earnings Management.*

Introduction

From the point of economic efficiency, the independent directors as an instrument of internal check and control are connected with the enhancement of corporate governance which increases firm value and lead to shareholders' wealth maximization of a company. This is no similar view as regards the impact of independent directors on firm's value creation because the empirical evidences on the correlation between independent directors and firm's wealth are not consistent and rather debatable. In recent times, the independent directors became the target of public criticism due to their weak governance role especially after several episodes of financial crisis and high profile corporate scams. In spite of controversies as regards the role of independent directors in corporate governance and shareholders' value, the institution of independent directors exists and they contribute not only to the improvement of corporate governance but also for the enhancement of shareholders' value, as a good governance process is but a means of causing better financial performance.

The relationship between independent directors and firm's value has been a more controversial issue of academic research in corporate governance literature. Several empirical studies that examine such relationship pinpoints to the effects of different facets of independent directors such as number, proportion, background, characteristics on the firm's financial performance. In fact, there is no clear-cut answer to this debatable issue because the results of empirical studies on whether the independent directors can improve corporate governance and shareholders' value are mixed. Generally, there are three types of empirical results in regard to the correlation between independent directors and firm's financial performance, which are either positive or negative or no relation exists between them.

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In this paper we have attempted a brief literature survey on the role of independent directors on shareholders' value enhancement. Section 2 deals with positive relationship. Section 3 discusses on the negative relationship. In the section 4 no relationship is explained and section 5 concludes the paper.

Positive Relation

Baysinger and Butler (1985), assert that an increase in the number of independent directors in the board, will improve the financial performance of the company. In a similar investigation, Rosenstein and Wyatt (1990), reveal that the announcements of appointment of independent directors are associated with the increase of shareholder's wealth, though there are majority independent directors in the company's board before such announcement. Daily and Dalton (1992), indicate that independent directors offer an intelligent tool in terms of expertise and resources when struggling for firm's growth. The results of an empirical study by Wagner et. al. (1998) reveal that the greater presence of independent directors in the company's board is associated with superior firm performance.

Alves (2014) asserts that higher proportion of independent directors on the board improves the earnings quality as compared to the firms with low proportion of independents directors.

As a trustworthy instrument of supervising the management functions, the independent directors would help to curb or limit managerial opportunism which in turn leads to better operational and financial performance of the company (Merendino and Melville,2019)

In a study Tham et.al.(2019), state that the independent directors (having multiple directorships) by sharing experiences ,information , skills and other resources restrain the level of earnings management by the firms. The authors suggest for appointment of independent directors with diverse backgrounds, relevant skill-sets and international exposure/expertise with multiple directorships which will assist the firms to determine optimal board composition for value enhancement of shareholders.

Interlocking independent directors (holding multiple board seats) by knowledge sharing among them help to improve firm's overall revenue streams and cash flows on a sustainable basis. Moreover, the governance and oversight efforts such directors contribute to minimize financial reporting anomalies and assist in proper valuation of shares of investors (Liao and Chen,2020).

The younger and reputed independent directors who cast dissent votes are likely to be rewarded by more board seats in other companies in the long run (Jiang et.al.,2016). Such dissensions help to discipline the management, attract media scrutiny, avoid legal actions, invite intervention by creditors and regulators which lead to significant stock market changes and shareholders' value enhancement.

Pang et.al.(2020) state that the academic independent directors in China with administrative experience create value for shareholders by their monitoring and advising functions.

Companies with more woman independent directors have better firm performance by market (Tobin's Q) and accounting (return on asset) measures. Terjesen et.al (2016) assert that such woman directors help in enhancement of board's effectiveness and firm value. The firms in more complex environments are likely to have gender balanced boards.

Sanda (2011) makes a study to examine the relationship between board independence and firm financial performance. The data of sample size of 89 firms listed with Nigerian Stock Exchange were used for statistical analysis. The research findings of the author suggest that the Nigerian firms should adopt better governance practices to make the board more independent and should avoid unnecessary interference on the functioning of CEOs in the important board committees so as to facilitate improved firm financial performance.

An exploratory study made by Lin and Chang (2014) on the samples of Taiwanese listed companies reveal that firm performance is positively related with the ratio of independent directors in the board. The authors also add that the independent director system is a very effective instrument for firm performance and the firms will be benefitted by establishing an independent director system.

Gordon (2007) states that the commitment of the firm is shareholders wealth maximization and this is best measured by the stocks market performance of the firm. The author argues that in this context, the independent directors are more important than the insiders. The author however suggests that the development of the institution of independent directors and the associated corporate governance paradigm are to be examined in the context of the overall achievement of social welfare.

Tinggi et. al. (2014) assert that the engagement of internal and external auditors for monitoring the day to day routine procedural compliance requirements is not sufficient. The authors report that the findings of their study suggest for majority of the independent directors on the board and this will enable them to exercise a more dominant role towards the profit orientation of the firms.

Saravanan and Shaw (2014) state that the network resources of the board and higher affiliation of the firm with its core industry through board will have significant positive effect on the firm performance. This establishes the fact that higher network connection of the directors will lead to higher firm performance.

In the article, *"The Role of Non-Affiliated Outside Directors in Monitoring the Firm and the Effect on Shareholder Wealth",* Block (1999) states that the outside directors with financial background as well as professional experience (especially with CEO background) are likely to arouse most positive response from investors.

Chou and Hamill (2011) find that the compliant firms which appointed independent directors and supervisors, had experienced significantly better operating results. Even the firms with poor results before implementation of the recommendations were significantly benefitted by appointment of independent directors and supervisors. The investors value the firm's decision to improve the board quality and the benefits associated with it.

In an empirical study, **Brown and Caylor (2004)** assert that the presence of the independent directors on the board helps in alignment of manager's role towards the interest of shareholders and also in the improvement of the authenticity and reliabilities of the public disclosures of the companies. Being outsiders, the independent directors can make credible evaluation of the firm performance and also reduce the information asymmetry between the shareholders and the management.

Cotter et. al. (1997) assert that the target firms with independent board can extract higher initial tender offer premium and also better bid premium revisions than the firms without independent boards. Moreover, the target firms with independent board are more successful than the firms without independent board in case of resisted offers or offers with the poison pills to target firms, in extracting higher gains for target shareholders. The authors conclude that the independent outside directors of the target firm play an important role in the wealth creation of the shareholders in the tender offer process and also in resisting offer with poison pills in comparison with the firms without independent board

Choi et. al. (2007), report that the board independence (measured by the proportion of outside directors on the board) should have a significant and positive impact on the firm performance in the post –economic crisis of Korea, and such relationship is stronger in the firms having true independent directors rather than those non –executive directors having professional ties with the firm (Grey director).

Negative Relation

Another section of empirical studies reports negative effects of independent directors on firm's financial performance. Hermalin and Weisbach (1991) reveal that different proportion of independent directors on the board makes no remarkable difference and rather have a negative impact on firm's profitability estimated by Tobin's Q. Klein (1998) by using a variety of market and accounting measures finds a significant negative relation between the ratio of independent directors and firm's financial performance.

Habbash et. al. (2014) report that the independent directors and the supervisors have failed to monitor the malfunctioning and also in restraining the earning manipulation by the management. The authors also report that the true independence of the independent directors and the supervisors has been compromised and they failed in controlling earnings manipulative activities.

Zahra and Stanton (1998) notice that the proportion of independent directors has a significant negative impact on the firm's financial performance.

Kumar and Sivaramakrishnan (2007) find that firm value or corporate financial performance can actually improve when board is more dependent on CEO or the management team, but decreases when more independent directors are in the board.

Lu. (2020) finds that the interests of stakeholders particularly, employees and consumers have been compromised as a consequence of myopic attitude of the board and such negative corporate social approach may not fully price the shares of the company by the market and the prospective investors.

The non verifiable and ambiguous reasons cited in the resignations submitted by the independent directors cause an immediate negative market response and are associated with firm's poor financial results, and the investors usually under react to such resignations (Bar-Hava et.al. (2018).

Declining firm specific knowledge and lower board commitments sometimes caused infrequent attendance and also resignations from the board by the distracted independent directors. Masulis and Zhang (2018) claim that firms with more preoccupied independent directors are characterized with declining firm valuation , reduced operating performance, weaker merger & acquisition profitability and inferior accounting quality.

Kishore and Jha (2012) reveal that the contribution of the independent directors was rejected as very insignificant and undesirable. The authors also note that the companies generally appoint or co-opt the independent directors for the sake of compliance of regulatory requirements instead of governance needs for ensuring transparency in the organizational functions. In fact, a sizeable number of independents directors have the casual approach in their jobs.

Fosberg (1989), analyses the effects of different ratios of independent directors on the level of managerial performance and also used extensive accounting tools to measure firm performance. The findings of the analysis reveal that the relation between the proportion of independent directors and financial performance of the firm is negative in general. Agrawal and Knoeber (1996) also confirm a negative and significant correlation between the proportion of independent directors and Tobin's Q suggesting that higher proportion of independent directors adds little to firm value.

Bhagat & Bolton (2008) assert that independent directors negatively affect firm value. They also state that independent directors should only be added to discipline the management in poorly performed firms. But there will be a negative effect on shareholders' wealth by just adding outsiders on the board.

No Relation

Several investigations reveal insignificant relations between proportions of independent directors and the accounting performance measures.

Rechner and Dalton (1991) report no relationship between shareholders' wealth creation and the board composition measured by the percentage of independent directors on the board.

Iwu-Egwuouwu (2010) asserts that though the presence of the independent directors in the board improves its governance practices but this does not necessarily guarantee better firm performance.

Wang (2014) finds that board independence has no significant impact on firm performance, the background and characteristics of independent directors have controversial impact on firm performance,

Duchin et. al. (2008) recommend that addition of independent directors on the boards does not help or hurt performance on the average.

The financial performance proxies such as Earnings Per Share (EPS),Return on Assets (ROA),and Return on Equity (ROE) are used in a study by Pasko et.al. (2021) which reports that the board independence has no significant correlation with the firm's financial performance and shareholders' value.

Vintila and Gherghina (2013) analyze the impact and causal relationship between board independence and firm value. Statistical analysis done by the authors do not prove any positive and significant relation between percentage of non-executive directors and the firm value.

Ritchie (2007) states that there is no guarantee that the persons conforming to the definition will exercise independent judgment. There are numerous ways by which independence can be compromised. Nexus among small elite group of professional directors is not uncommon. It will be a mistake to assume that mere compliance with governance norms will ensure exercise of independent judgment by the board and good corporate governance. A survey done by Bhagat and Black (1999) repots that the firms with super-majority independent directors are less profitable than other firms and suggest that the firms should have the moderate number of independent directors (three to five in the average sized eleven members' board).

In the article *"Corporate Governance –Independent Directors and Financial Performance: An Empirical analysis"* Krishna (2006), suggests that the empirical analysis of her study produces no evidence to confirm any relationship between maximization of firm value and independence of board.

Lawrence and Stapledon (1999) under the research heading *"Do Independent Directors Add Value?"* made a survey of the top 100 Australian firms listed on the Australian Stock Exchange to measure the relationship between corporate performance and board composition. The findings in the study reveal that:

- There is no evidence that the proportion of independent directors has any influence on the company's managerial resources.
- There is also no evidence that manager-dominated board could produce superior returns to shareholders.
- Share price data show that board composition do not really matter.

Conclusion

From analysis of the extant literatures, it is observed that there have been tremendous controversies on the issues such as impact of board structure, board characteristics, CEO – Duality etc. on the firm financial performance and shareholders' value. But no conclusive evidence has been found on their relationship (Hermalin & Weisbach, 1998). Moreover, there is wide variations in the role and composition of the boards across the world. Since the concept of corporate governance is new to the emerging economics like India, adequate literatures are not available to delineate the causal impact of board composition on firm financial performance and shareholders' wealth creation. Even from the available literatures, no empirical work was found in relation to the role of independent directors in shareholders' wealth enhancement.

Further research is needed to conclusively ascertain why majority executive directors on the board deliver better firm performance than independent directors do, and it appears that in many cases majority or super-majority independent boards are in reality associated with negative financial performance. Similarly we have to make further analysis as to why studies on this subject matter appear to be culture-board due to which results obtained in some continents such as North America differ substantially from those obtained in other continents including Asia.

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