Board Games

International lens on board structure reveals dynamics beyond director independence

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The Enron scandal of 2001 and subsequent regulatory reforms changed the laws governing corporate board structures by mandating that boards increasingly be comprised of independent members rather than company executives. Since then, academic scholarship has studied the impact of independent boards on executive compensation, mergers and acquisitions (M&A), performance and other metrics.

Their findings have proven inconclusive. Finance professor Mihail Miletkov believes the culprit is “endogeneity.”

“They’ve been looking in the wrong places,” Miletkov says, adding that most researchers focus on U.S. companies, which — again, since Enron — operate in uniformly well-regulated environments. “It’s hard to see whether the board or management or some other factor is responsible for change.” Widen your study to include international firms, says Miletkov, “and you begin to see clear relationships between board composition, a country’s social and legal frameworks, and company performance.”

For example, companies operating in nations lacking strong oversight, such as that provided by the Securities and Exchange Commission in the U.S., benefit from the presence on the board of a director from a country with strong legal institutions who can help the firm reduce agency costs and protect investor rights. When it comes to M&As, says Miletkov, “markets respond more positively when M&As involve companies with legally sophisticated foreign directors.”

Miletkov also has drawn a direct relationship between board composition and companies’ ability to overcome home bias and attract foreign capital.

“Previous literature says investors are reluctant to invest abroad because they feel exposed to potential fraud in countries with weak legal frameworks,” he says. “We found that in countries with poor legal institutions, foreign investors were attracted to companies whose boards had more independent directors. At least somebody was on the lookout ensuring minority shareholder rights were respected.”

Even his most recent paper, which focuses on the relationship between board composition and tax avoidance strategies at thousands of publicly traded U.S. companies, offers an international twist.

“Most studies of U.S. boards look at director characteristics such as education, industry experience, or ethnicity and gender,” says Miletkov.

He and his coauthors looked at what happened when U.S. company boards included “island directors”, i.e., people who also sit on the boards of off-shore companies, and found these U.S. companies engaged in significantly higher levels of tax avoidance.

“It’s a huge social and economic issue, worth many billions in unrealized tax revenues,” Miletkov says.

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