Board composition and corporate governance—A multivariate analysis of listed Danish firms

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Abstract The article conducts a multivariate analysis using a sample of listed Danish firms in order to examine what describes board composition. This issue also relates to corporate law that stipulates the legal boundaries of board composition. In recent years, several European countries, including Denmark, have issued various codes for good corporate governance, in the form of soft law. Such initiatives have been launched, even though the questions of what describes board composition, as well as, the legal profession’s influence on board structure, have not been fully uncovered. This study shows that four factors explain Danish board structure. These factors can be interpreted by the following dimensions; the lawyer oriented, the business person oriented, the internationally oriented and finally the traditionally oriented board. Thus, the paper shows that a higher proportion of insider ownership increases the first dimension, whereas a higher remuneration increases the business person orientation of the board. If firm size increases, the international dimension of the board increases and if a firm experiences less growth board structure becomes more traditional.

Keywords Board composition · Corporate law · Corporate governance · Multivariate analysis

JEL Classification G32 · K22

1. Introduction

The composition of corporate boards has gained increasing attention within recent years and much effort has been devoted to understand the nature of corporate boards. The obligations of the board are usually determined by law in the state, where the firm is incorporated, but the law offers no guidance of how the board should be composed. The literature within corporate governance has not yet provided a satisfactory answer. This article seeks to dismantle the
black box view of corporate boards by providing a better understanding of the forces that interact with board composition.

The organization of management in listed firms plays a crucial role in corporate governance, where the objective is to develop certain structures that align the interests of management and investors see, e.g. Blair (1995) as well as Easterbrook and Fischel (1991). Much effort has been devoted to the study of how the presence of outsiders on corporate boards may discipline top management. The idea is that outsiders by definition are more independent, and as a consequence, more efficient in monitoring and controlling top management. However, the empirical evidence does not seem to relate the proportion of outsiders to firm performance - only when there is a change of the proportion of outsiders. A possible explanation is that the measures used in many studies rely on hard data that are not capable of describing all facets of the nature of corporate boards. The proportion of outsiders may not be an adequate proxy for a board’s independence. For instance, when a CEO is member of the board, in a firm where the firm’s outsiders serve as insiders, or when there is a social or family relationship between the CEO and the outsiders, outsiders do not qualify as independent board members.

This suggests that there is a need for a deeper understanding of how corporate board’s works, as well as what describes board composition. For instance, are corporate boards characterized as highly diversified or are they a mirror of the “old boy’s network”, dominated by persons with a legal educational background.

Knowledge of what constitutes board structure may assist in evaluating, whether certain board structures are more efficient than others, as well as, how external factors influence a given board structure. Specifically, how do factors such as the board’s remuneration, ownership by insiders and firm size impact the composition of the board? For instance, which factors explain whether the board is traditionally composed, dominated by old men with a background in engineering?

In recent years more attention has been paid to the diversity of corporate boards i.e. how the board is composed in relation to gender, ethnic background, education and proportion of foreigners etc.

Increased board diversity may facilitate an enhanced competence profile for the board as a whole, as this avoids that a number of qualified board candidates, not normally considered when searching for new members, are excluded. In addition, a firm with a higher degree of board diversity can signal to its surroundings, including its employees that positions of top management are not only restricted to the “old boys network”, thereby increasing the firms image hoping to attract well qualified job applicants. In the rest of Scandinavia, there is a large ongoing discussion about how to increase the number of women in corporate boards. Specifically, the Norwegian government has planned to increase the proportion of women on boards from 7.5 percent in the year 2002 to 40 percent in the end of 2005 (Wall Street Journal, July 19, 2002), but whether this will be accomplished is still unknown.

Traditionally, one distinguishes between the one tier and the two tier board system. The one tier system does not only prevail in countries based on Common law. For instance the UK Companies Act allows for a defacto two tier structure and France follows the tradition of the one tier board and offers the choice between two other models. In some countries, e.g. in Germany and Austria, members of the supervisory board are not entitled to join the board of managing directors.

An advantage with the two tier board system is that it may strengthen the supervisory board’s independence. Specifically, it may avoid a situation, in which managers in the firm do not challenge the CEO, when the person engages in opportunistic behavior, since they may fear loosing their job. One the other hand, one may argue that when a board also consists of persons working within the firm, monitoring efficiency increases. The reason

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