Director Interlocks: Information Transfer in Board Networks

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Director interlocks occur when a board member or an executive of a firm sits on the board of directors of another firm. As an essential social network application in the business world, interlocking directorates are documented to be non-trivial from the 1930s and continue to gain popularity thereafter. Corporate information and business practices can be transferred to another firm through an interlocking director sitting on both companies' boards. Such information dissemination leads to changes in an interlocking firm's decision-making processes. Existing business research attempts to decipher the underlying reasons why board interlocks become prevalent, how and what information is being transferred through this channel, and the intended or unintended consequences to firm strategic, governance, financing, and accounting practices. We first introduce theoretical research on board interlocks in management and then follow up with empirical evidence in finance and accounting. Since extant studies have not reached a consensus on various consequences of board interlocks, we contribute to the literature by summarizing the findings from multi-business disciplines, discussing their advantages and disadvantages, and calling for more research on the topic.

board interlocks | interlocking directorates | social networks | information transfer | information dissemination | information contagion

As an essential social network application in the business world, director interlocks occur when a board member or an executive of a firm sits on the board of directors of another firm [1][2]. Network theories suggest that social ties facilitate the diffusion of information [3]. Board interlocks, as a form of low-cost channel for information transfer, have been documented to be associated with the diffusion of firm operating, governance, financing, and accounting practices. Interlocking firms benefit from the information transferred and expertise shared through board networks in terms of reduced environmental uncertainties [4], better governance, and anti-takeover defenses [5][6].

However, because the interlocked directors are likely less independent than outside directors who are not linked to other boards [7], director interlocks are sometimes viewed as less effective in governing and, thus, suboptimal in performing the board monitoring role. In addition, the information transfer channel could also exacerbate the dissemination of non-value-added practices at the expense of shareholders. Consistent with this view, studies show that board interlocks lead to reduced voluntary disclosure [8], dissemination of earnings manipulations [9], higher levels of tax avoidance [10], and suboptimal executive compensation schemes [7][11]. Collectively, while the benefits of director interlocks are salient, it is nonetheless exigent to study the costs and adverse consequences associated with such ties.

Initially explored in the regime of strategic management studies, scholars propose multiple models that attempt to explain why such interfirm networks gained popularity among firms despite debates about possible negative consequences and the legitimacy of board interlocks. More recent finance and accounting applications provide further evidence of costs and benefits associated with director interlocks. Specifically, finance studies explore director interlocks as a meaningful mechanism in corporate governance practices such as anti-takeover defenses, merger and acquisition activities, and executive compensation, whereas the accounting literature provides insights into how director interlocks affect firms' financial reporting, auditing, and tax avoidance activities.

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