



Independent Directorship and Corporate

Performance: Some Further Testing from the China Case

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Abstract

This study attempts to re-examine several hypotheses suggested by the literature concerning the relationship between corporate governance and corporate performance using the data from China. The findings of the paper suggest that corporate performance in China is mostly influenced by other economic variables, not by corporate governance and the hypotheses that corporate governance will have positive on corporate performance is not valid. This poses a question for China as to whether the current top-down approach to corporate governance (which is largely based on duplicating the Anglo-American model) will be effective in linking the firm performance and independent directorship.

Keywords: Independent directorship, Corporate governance, Chinese economy.

1. Introduction

The relationship between corporate governance and corporate performance remains as one of the important topics in the literature of corporate governance. Corporate governance is expected to improve firm performance and efficiency and the use of independent directors is one important symbol of better corporate governance. However, one has been debating on whether there is an empirical relationship between them corporate performance and corporate governance/independent directors. There are two popular hypotheses concerning this empirical relationship: one is that companies with better corporate governance, usually represented by having independent directors, will lead to better firm performance and efficiency; another is that companies with higher percentage of independent directors on the board will improve corporate performance.

The empirical studies on the topic have been limited and inconclusive. In particular, one finds limited empirical studies on China in relation to the relationship between independent directorship and corporate performance. This paper attempts to apply the data from China to shed some light on this interesting topic.

2. A review

Corporate governance has been an important topic for research, and the use of independent directorship, which is an important part of corporate governance, is the reflection of the change in modern business environment as shown by the more diversified corporate ownership, the separation between corporate ownership and management, and the increasing control of corporate management over the stake of the company. In order to avoid insider collusion or CEO's domination, more outside directors are preferred, especially those without any affiliation with the firm (see, eg., Fama, 1983 and Dalton et al., 1998). Therefore, it is suggested that independent directors will protect the interest of shareholders and improve corporate governance so as to achieve better corporate performance.

An independent director or "outside director" and/or "non-executive director", is defined as the director appointed by the company as a member of the board of directors who has no financial interest in the company and hence is independent of the management of the company (see, e.g. Jensen and Meckling, 1976 and Fama, 1980). Recently Jensen and Meckling (1976), Fama (1980), Fama and Jensen (1983), Word Bank (1999) has made more comprehensive discussions on the importance of independent directors. The similar arguments can be found in the studies by Kimber (1969) and Tricker (1978). As such, independent directorship have become a common practice for corporate governance in OECD countries, it is not uncommon that majority of board of directors are composed of independent directors in western companies (eg., a recent survey by Economist reveals that some 88% of American companies whose board of directors are largely represented by

external/independent directors).

The roles played by an independent director in improving corporate governance and corporate performance can be seen, as argued by in the literature, through his supervision and monitoring of the company management (ie., to solve the so called “agency cost”), his consultancy and advice to provide help in new technology, marketing and other expertise; his political role and connections, which will promote the marketing of the company; his “buffer” role to protect the interest of different groups between management, shareholders and the regulatory institutions; In particular, an independent director is expected to promote transparency and social morality of the company in complying reporting, accounting and disclosure requirements as set by the regulation. Thus, it will usually improve the image of the company in the eyes of public and hence promote reputation of the company, which will improve corporate performance.

However, the empirical studies on the relationship between independent directors and corporate performance have been inconclusive. On one hand, Rosenstein and Wyatt (1990) has found that there is significant and positive relationship between independent directors and share prices of the company, with a higher return on average. They also found that the percentage of independent directorship of the board of directors is positively correlated to the market value of the company. Friday and Sirmans (1998), base on a study on independent directorship and the wealth of shareholders from real estate investment trust, found that the wealth of shareholders will increase when independent directors have more seats of the board of directors. Further, Suchard, Singh and Barr (2001) have found that there is a relationship between CEO turnover and lagged performance rather than current performance, and further, non-executive directors and independent directors are more likely to monitor management. Block (1999) finds that the announcement of the appointment of an independent director is likely to produce positive abnormal returns. Ghosh and Sirmans (2003) argue that alternative monitoring mechanisms, including external directors must be in place to discourage deviant managerial behavior. Using a simultaneous equation system, they found that while independent directors enhance REIT performance, “Outside board members seems to enhance performance” (Ghosh and Sirmans, 2003, p.287). Similarly, Gomers, Ishii and Metrick (2003) found that firms subjected to effective corporate governance through stronger shareholder rights have higher market values, profit and sales growth and lower cost of capital. Lehman and Weigand, (2000) also indicated that corporate governance is associated with economic performance of firms.

On the other hand, Fosberg (1989) found in his empirical study that there is no relationship between independent directorship and corporate returns. In particular, he provided empirical evidence that a higher independent directorship percentage has no relationship with corporate performance. The similar finding can be found in William and Brown (1996), Hermalin and Weisbach (1988) and Bhagat and Black (1999). In particular, Ford (1988) has shown that a mixed board of directors where independent directors are included are doing much less satisfactory job than a board of directors, which only includes executive directors.

In particular, some scholars point out that incentives exist for collusion between independent directors and top management to the detriment of outside shareholders (Mangel and Singh, 1993). Some even argue that firm with a high percentage of independent directors may perform worse (Yermack, 1996). This is because inside directors have superior knowledge of the firm and its industry, who also work as diligent as outside directors, therefore, they can be more effective than those outsiders (Rosenstein and Wyatt, 1997). Further study from Bhagat and Black (1999) suggest there is no convincing evidence suggesting that greater independence results in better performance, but some evidence shows that firms with super-majority independent boards perform worse than others.

3. The Problem

Corporate governance and the use of independent directorship in China is a recent phenomenon as China has further reformed its financial market and corporate system. The use of independent director can be traced back to 1993, when TsingTao Beer H Share was listed in Hong Kong and was request to invite at least two independent directors into the board of directors. In 1997, 1999, 2000 and 2001, China has issued several regulations, which made provisions for the listed companies to include independent directors. As such, about 90% of the listed companies in China in 2003 have independent directors as opposed to some 60% in 2001.

Some typical problems frequently occur in the Chinese corporate world are the insider control issue, the unfair related party transitions and the highly concentrated state ownership in the corporate ownership. A number of corporate governance ranking surveys suggest that the practice of corporate governance in China is still lagging behind other Asian countries, such as Singapore, Korea, Malaysia, Thailand or the developing markets like Brazil, Romania, Czech Republic etc. (see., eg., Fremond and Capaul, 2002).

The state owns about 50% of all the shares of listed companies (Wu, 2003). According to a study by He (1998), there is highly concentrated ownership in Chinese company where the state as the so called “inside director” is the largest single shareholder. Figure 1 indicate that the state as a single shareholder owns about 1/3 of all shares in the listed companies, and the three major shareholders (and they are in most cases state-owned entities) account for most than ½ of all shares in the listed companies. It is found that about 50% of the listed companies where 70-80% of shares are controlled by these inside directors(Wu, 2003).

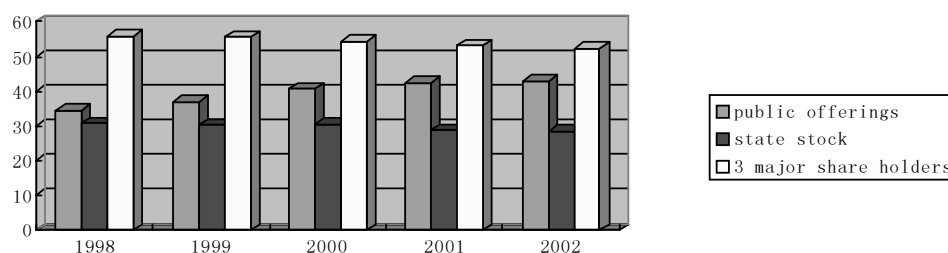


Figure 1. The Equity Composition (%)

The centralized ownership structure ultimately gives the leading shareholder the ultimate controlling power to determine firm's business movement and development. In order to protect the interests of nearly 60 million minority shareholders in China, CSRC has emphasized on strengthening board independence to improve corporate governance of the Chinese companies. And the "Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies" was released accordingly. Therefore, China has learned from the west and introduced independent directorship to improve corporate governance in China (Note 2) Lin (2001) argued that actual governance of corporatised Chinese firms are however seriously defective, characterized by excessive power of CEOs, insider control and collusion, lack of safeguards for minority shareholders and weak transparency, but above all, there is continued state dominance in ownership and control of the corporate sector and listed company. Therefore, independent directors will be one of the measures which improves corporate governance in China.

Chen (2001), based on cross-sectional relation between ownership structure and corporate performance of a sample of 434 manufacturing firms listed on the Chinese stock exchange, has found that there is a strong relation between ownership concentration and corporate performance. Xu and Wang (1999) investigated whether ownership structure and a mixed structure including independent director significantly affects the performance of publicly-listed companies in China. They found ownership is heavily concentrated: the five largest shareholders accounted for 8 percent of the outstanding shares in 1995, compare with 57.8 percent in Czech Republic, 79 percent in Germany and 33 percent in Japan. Their empirical analysis shows that the mix and concentration of stock ownership do indeed significantly affect a company's performance. Further, labor productivity tends to decline as the proportion of state shares increases. The results suggest the importance of large institutional shareholders in corporate governance, the inefficiency of state ownership, and potential problems in an overly dispersed ownership structure.

Fung and Leung (2001) argued that Chinese financial liberalization will have significant implications for corporate governance in China and independent directors will be vital for Chinese corporate performance. Mar and Young (2001) conducted a study which examined the extent to which listing of shares of Chinese state-owned enterprises on public stock exchanges – a key part of the on-going reforms – is associated with convergence of their corporate governance practices toward those accepted as global standards. Wei and Varela (2003) conducted a research, which examines the relation between state equity ownership and firm market performance for China's newly privatized firms in 1994 (164 firms), 1995 (175 firms), and 1996 (252 firms). The overall results show that state ownership has a negative effect on firm value. One of the implications from their study is to improve corporate ownership by including independent directors.

Chen (2002) is among very few researchers who have done a preliminary empirical study on the relationship between independent directorship and corporate performance. Using the data from 53 companies, he has found that there is no relationship between the size of board of directors and corporate performance, and state stock has the most important impact on company performance. Most importantly, he found that there is a negative relationship between independent directors, measured as the percentage of independent directors in the board of directors, and corporate performance.

Current Chinese corporate governance model is largely a duplication of the Anglo-American model, and it has been pushed as a top-down framework in China. Tam (1999) argues that "[such an approach] is not effective and unlikely to serve its intended purposes unless complementary conditions can be created or developed," and further, there are "alternative functioning systems of corporate governance" (Tam, 1999, p.3).

It is thus obviously difficult for independent directors to achieve better corporate governance and firm performance due to its problem of "foreign seed being planted on the Chinese soil". The difficulty of making independent directors work in China lies in its cultural, political and economic roots arising from the old regime. Traditionally and culturally, an "outsider" to the company such as independent directors, if they have no CEO title, will not be respected for the opinions they wish to express. In some cases, the company executives are hostile to an outsider. The company will respond more to the CEO rather than to its independent directors. A survey conducted in 1999 by Tam (1999) shows an interesting finding concerning the attitude of company executives towards non-executive directors, or independent directors: about 64% of company executives (inside directors and managers/supervisors) wants more company executives to join the board of directors and only some 30% of the surveyed believe there should have more outside independent directors. In such background, it is difficult

for independent directors to obtain the company information and to perform their job well.

The “independence” of independent directors is often questionable in China as independent directors are usually appointed through their old-time supervising ministries or current seemingly government-controlled shareholding company (a typical phenomenon in the transition phase in China as one of the “Chinese characteristics”), or because he/she is the old mate of the CEO or the top executive. Therefore, independent directors in China are more or less “résumé independent directors”. Scandals such as the collusion between independent directors and top management to the detriment of outside shareholder are frequently reported in the media since the incentives exist for such collusion in some listed Chinese companies (Wu, 2003).

Recent reports on the performances of independent directors in China are striking: one independent director was fired due to his reports on the accounting fraud of his company (Note 3); Leshan Electric Co. management had stopped an independent investigation, although it was supported the China government, conducted by its two independent directors; and one independent director had resigned from his company, Xinjiang Tunhe Co. after his long battle with the management concerning the release of the information from the management to him (Note 4). To reflect this concern about the “independence” of independent directors, a survey conducted by Shanghai Securities Daily in 2004 provide further worries in this regard: 33.3% of the surveyed independent directors said they had never vetoed any decisions made by the Board; 35% of them had never expressed a different opinion against the management; and 15% said they are one way or another cheated by the management in the information release and decision making process. Further, 35% of them believe that they do not share the same information and the decision process as other directors in the Board (Note 5).

Other reasons that independent directors do not work well include the corruption occurred in some of the Chinese listed companies and the lack of the supervision. Those who are seeking a huge profit through unfair related party transition would not want an outside director to sit on his board. Wu (2003) pointed out that unfair related party transition includes large shareholder and its affiliates misappropriate or transfer the capital, assets or other resources of the listed firm through various means. The legal institutional procedures and related code of corporate governance in China are also different from those of the west. For instance, shareholders’ meetings in China were often not conducted in the same manner as in the west. Tam’s survey in 1999 indicates that only 16% of the surveyed companies allowed shareholders to freely participate in shareholders’ general meetings.

Ultimately, one would ask this question: is there a direct link, or an empirical relationship between corporate governance/independent directorship and corporate performance? Therefore, to link directly the firm performance and corporate governance may over-estimate the role played by independent directors, as confirmed by the empirical analysis below.

4. The Model and Findings

We first undertake some descriptive analysis of the two samples we have selected: the listed companies which include independent directors and the listed companies which have not included independent directors. The findings are shown in Table 1 and Table 2.

It is interesting to note that the sample data shows that the companies which has an independent director does not show significant differences in its share price, net return and other performances measures, compared to those companies without independent directors. One cannot find significant differences in share price, and return per share according to a formal hypothesis test for two populations (Note 1) in the means. This suggests that whether there is an independent director or not in the board does not make the statistical difference in the firm financial performance.

Table 1. Companies with independent director

	average	Sd.	max	min	median
Company size	14.4327	1.0221	18.791	12.3113	14.2769
Growth of Company Size	24.6934	10486.63	1202.9988	-91.03	10.188
Stock price					
Return/share	0.1918	0.0952	2.09	-1.0127	0.161
Net asset/share	3.0448	1.8381	10.135	-3.69	2.94
net return	5.333	107.7229	41.62	-266.09	5.83

* All variables are expressed in Chinese currency, Yuan, except company size is in logarithm forms and annual growth of company size in %.

The data used in this paper is compiled from the FinDataLink, Guanghua School of Management, Peking University, China Stock Market Database -CSMAR2004, and China Securities Regulation Commission (www.csrc.gov.cn). There are 490 companies altogether with 92 percent of them including independent directors and the rest do not. The models were estimated using SPSS. Variables are transformed to logarithm form. Because the impact of independent directors on corpo-

rate performance by and large has a lagged effect, we have used the 2004 data for dependent variable and the 2003 data for independent variables.

Table 2. Companies without independent director

	average	Sd.	max	min	median
Company size	14.5363	5.2764	21.56	12.69	13.80
Growth of Company Size	39.9906	2505.223	152.66	-22.28	18.34
Stock price					
Return/share	0.2517	0.05087	0.874	-0.09	0.1822
Net asset/share	3.9106	2.2645	3.08	1.36	3.765
net return	6.2017	19.5114	16.27	-6.18	5.53

* All variables are expressed in Chinese currency, Yuan, except company size is in logarithm forms and annual growth of

To test the hypotheses raised earlier, we wish to examine (i) whether the companies with independent directors perform better than those without, and (ii) whether there is an empirical relationship between percentage of the independent directors on the board and the firm performance. The models will use cross-sectional data from 490 Chinese listed companies in 2003 and 2004.

The dependent variables (to measure the firm performance) used in the models are, respectively, MBt, which is Market-to-book Ratio (defined as the ratio of market share price to book value per share), and share price of the company (which is average share price of the company).

The independent variables used in the models are, accordingly, NRPS_t (net return per share), MAJOR_t which is the percentage of shareholding controlled by three largest shareholders, POIND_t, which is the percentage of independent directors on the board; and finally, STAT_t and IND_t are dummy variables, i.e.,

$$IND_t = \begin{cases} 1 & \text{if company includes independent directors} \\ 0 & \text{if not} \end{cases}$$

$$State_t = \begin{cases} 1 & \text{if company is largely state controlled} \\ 0 & \text{if not} \end{cases}$$

The regression models are as follows according to the two hypotheses raised earlier, independent directors and its percentage on the board improve corporate performance:

$$MB_t = \alpha + \beta_1 STAT_t + \beta_2^+ IND_t + \beta_3^+ NRPS_t + \beta_4^+ POIND_t + \mu_t \dots \dots \dots (1)$$

$$P_t = \alpha + \beta_1 MAJOR_t + \beta_2^+ IND_t + \beta_3^+ NRPS_t + \beta_4^+ POIND_t + \mu_t \dots \dots (2)$$

The signs above each variable in the above models indicate the expected signs of the relationship between each dependent variable and its independent variables. In model 1, a higher return per share, NRPS_t, will no doubt increase net return on asset of the company as postulated by the theory. While IND and POIND are the focus variables which we expect to be positive, as argued in the literature, the effect of STAT is not certain as some economists have argued that a heavy state controlled shareholding, particularly in the Chinese case, have a negative impact on the performance of Chinese listed companies, but others had stated the opposite.

In the model 2, we include MAJOR, which is the percentage of the first three largest shareholders of the company. It is established in the literature that the higher degree of the share ownership by few largest shareholders, the higher is the fluctuations in share price (Chen, 2001). The definitions and coverage of other variables are the same as in Model 1.

Given the research topic of this paper, we wish to test whether the dummy variable, IND, and another independent variable, POIND, are significant in these models. The use of dummy variables is to make distinctions between those companies who have included independent directors and those who do not. If the dummy variables are significant and positive, we then can establish the Hypothesis 1 that independent directors do improve corporate governance in terms of improving their corporate performance, such as its share price and market value. To test Hypothesis 2 (i.e., the percentage of independent directors on the Board will improve share price and market value of the company), we test the significance of POIND, if it is significant, we can conclude that the Hypothesis 2 is valid.

Table 3 reports the regression result for model 1. The model is generally satisfactory in terms of conventional statistical criteria and the expected signs. A graphic examination of the relationships amongst dependent variable and residuals

indicates no sign of heteroscedasticity and reveals that they are normally distributed. The Goldfeld-Quandt test statistic also confirms the same result (Note 6).

Table 3. The MB Model

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	3.246	.129	2.13	25.124	.000
STAT	-.115	.096	-.055	-1.197	.233
IND	.034	.094	.017	.367	.714
NRPS	.792	.044	.830	17.945	.000
POIND	0.114	.095	.326	1.188	0.243

Dependent Variable: MB

Adjusted R2= 0.678

ANOVA, F= 108.163, Sig. = .000

Table 4. The Share Price Model

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	3.342	.720	1.26	4.640	.000
IND	.006	.067	.007	.086	.931
MAJOR	.192	.179	.105	1.078	.103
NRPS	.131	.033	.327	3.978	.000
POIND	.005	.699	.007	.087	.923

Dependent Variable: P

Adjusted R2= 0.432

ANOVA, F= 4.045, Sig. = .004

We found that Market-to-book Ratio, MB, is influenced mostly by net return per share (7.9% of change in MB for 1% change in NRPS). It is interesting to note that the STAT variable (government-owned companies) has a negative impact on MB, and hence it confirms the hypothesis that the state-owned enterprise has much poorer performance in China. It poses the need for further reform in the state-owned companies.

However, both IND and POIND are not significant in the model, and hence indicate that there is no empirical relationship between corporate governance and firm performance. The results for model 2 are shown in Table 2. They suggest that the three largest shareholders in the company, as expected, influence the changes in the share price although it is marginally significant in the model. NRPS also has a significant impact on the movement of the share price. This is because good net return per share sends a strong signal to prospective investors that the company concerned is a potentially strong performer and hence attracts more investments, pushing up the share price.

However, as in the model 1, both IND and POIND are not significant in the model, and hence indicate it is not significant for the changes in share price whether there are any outside directors on the board, or there is a higher percentage of independent directors on the board. Thus, again, one cannot find an empirical relationship between corporate governance and corporate performance.

The insignificant roles played by the Chinese independent directors have confirmed the argument earlier in Section 2 that the use of independent directors in China is more or less “foreign seed being planted on the Chinese soil”, and will have a long way to go in improving corporate governance in China.

5. Concluding remarks

This paper has used the cross-sectional data of 650 listed companies from China to test the hypothesis that independent directors will improve corporate governance in improving company performance and efficiency. The study shows that corporate governance, as measured by the significance and the percentage of independent directors on the board, do not have a direct and significant relationship with firm performance (share price and market-to-book value). Therefore, the hypothesis that independent directors will improve corporate governance and performance is not supported by the empiri-

cal findings of this paper, at least not from the Chinese experience.

This finding poses an important question for China as to whether the current top-down approach to corporate performance, which is largely based on duplicating the Anglo-American model, will be effective in linking the firm performance and independent directorship when there is a wide debate on the topic in the west and alternative systems of corporate governance are available.

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Notes

Note 1 The hypothesis is: $H_0 : u_1 = u_2$ and $H_A : u_1 \neq u_2$ where u_1 represents population men in the sample with independent directors and u_2 represent population mean in the sample without independent directors.

Note 2 According to the Guideline, listed companies should have at least two independent directors of the board of directors by 30 June 2002, and at least one third of board members shall be independent directors by 30 June 2003.

Note 3 Yili Ltd. made the decision on the 16th June, 2004. Beijing Youth Daily, the 19th June, 2004.

Note 4 Beijing Youth Daily, the 19th June, 2004.

Note 5 Shanghai Securities Daily, May 30, 2004 and CAAC Journal, June 2, 2004.

Note 6 They are not reported here but available upon request.