Corporate governance and risk-taking of Chinese firms: The role of board size

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Abstract

The corporate governance reform in China offers an interesting context for investigating the systematic relationship between board size and firm's risky policy choices. Our results indicate that firms with smaller boards experience larger variability in future firm performance. These firms are also associated with higher executive pay-to-performance sensitivity, tend to pursue riskier investment policies, and engage more frequently in earnings management. However, Chinese firms with smaller-sized boards are found to be more conservative in using debt financing. Overall, our Chinese evidence is consistent with the hypothesis that board size has negative impacts on firm risktaking.

Keywords: Board of directors, Corporate governance, Risk-taking, China

1. Introduction

The corporate board of directors is an essential governance mechanism that alleviates the agency problem between management and shareholders. Indeed, it is the board that hires/fires the top management, designs the managerial compensation package and ratifies almost all important financial decisions. One aspect of board characteristics that may affect its ability to function effectively is the size of the board.

Lipton and Lorsch (1992) argue that as a board gets larger in size, slow decision making and free rider problem cause the board to function ineffectively. Hence, firms should embrace small boards (see also Jensen, 1993). On the other hand, a larger board may play a better advisory role (Coles, Daniel, & Naveen, 2008; Dalton, Daily, Johnson, & Ellstrand, 1999). Despite the fact that there is no optimal board size for all firms, the size of the board appears to affect corporate value (Coles et al., 2008; Eisenberg, Sundgren, & Wells, 1998; Uchida, 2011), firm policy choices and risk-taking. Yermack (1996) finds that CEO's pay-performance sensitivity decreases with board size, suggesting that smaller boards are more likely to induce value-increasing but potentially more risky managerial decisions than do larger boards. Consistently, Cheng (2008) shows that firms with smaller boards exhibit higher contemporaneous performance variability and Wang (2012) documents that board size has impact on the incentive feature of managerial pay and investment decision as well as the subsequent firm risk.

However, these findings do not strongly hold when the study is extended to other markets. Nakano and Nguyen (2012), employing an approach similar to Cheng (2008), find that Japanese firm risk does not decrease as much in relation to board size as for US firms. They argue that insider-dominated Japanese boards along with the homogeneity and greater conformity seeking in Japanese culture weaken the link between the size of the decision body and the variation of the decision results. This finding that the extent to which firm risk is related to board size can be affected by cultural differences and distinctive institutional environments,
leads us to wonder what role board size may play in explaining corporate risk-taking in China, the world's second largest economy where its culture, institutional and regulatory systems are different from many other countries.

Over the past three decades China has successfully transformed from a centrally planned economy to a mostly market-based economy and has been well-integrated to the global financial markets. More recently the country has also undergone vast improvements in corporate governance. Many Western-style oversight mechanisms and legal standards concerning corporate operations have been adopted and concerted efforts have been made by Chinese regulators and firms to align accounting and governance practices with those in developed markets. However, there are still various institutional and cultural factors in China that make our research of Chinese corporate board size and its influence on firm risk distinct from prior studies on US and Japan.

First, the state ownership is still prominent in many Chinese listed firms. According to China’s Company Law, the board of directors has authorities to draft budget and operation plans, and make decisions on all important issues, including investments, financing, and the appointment, removal and the remuneration of the executives (Articles 47 and 109). In this regard, the board of directors is the de facto ultimate strategic decision making authority in Chinese firms and managers are more of operational decision makers (Kang, Shi, & Brown, 2008; Oppen, Wong, & Hu, 2002). However, as the state is the controlling shareholder of many listed companies, with considerable power on the appointment of board and supervisory board members. Chinese boards are populated with insiders or members with political connections. For example, Chen, Fan, and Wong (2006) study the boards of directors of 621 companies from 1993 to 2000 and find that about 52% of the directors are former or current employees of the largest shareholders, and that about 32% are current or former government bureaucrats. This casts doubt on how much actual influence the Chinese boards may have on corporate policy choices and risk taking.

Second, the size of the Chinese boards is not entirely determined by the firm's needs but is limited to a specific range stipulated by regulation, resulting in a relatively smaller variation in board size across Chinese firms. In the US there is only a requirement on the minimum size of the board (≥1), while there is no restriction on the upper limit. However, the China Securities Regulatory Commission (CSRC) Code explicitly states that the board of directors be composed of not fewer than 5 but not more than 19 members. Specifically, the standard deviation of board size for our Chinese sample firms is 1.996, much lower than that for Japanese firms (4.59, as reported in Nakano & Nguyen, 2012) and that for US firms (2.7, as reported in Wang, 2012). Such a small variation in Chinese board size presumably makes the estimated relationship between board size and firm risk much weaker, if there is any.

Third, cultural differences should play a role in the risky choice of Chinese corporate boards. Social psychology research shows that the group decision may become more cautious (or risky) than the mean of individual decisions of the members if the group values being relatively cautious (or risky), since the members tend to conform to the social norm (Brown, 1965; Stoner, 1968), and the shift is related to the group size and whether the group is composed homogenously or heterogeneously (Teger & Pruitt, 1967; Watson & Kumar, 1992). According to Hofstede's (1985) and Hofstede, Hofstede, and Minkov (2010) national culture value survey, China values collectivism even more than Japan, in sharp contrast to the US's valuing individualism. Cultures low on individualism emphasize strong group cohesion and firms in low individualism societies are found to be associated with low risk-taking (Li, Griffin, Yue, & Zhao, 2013; Mihele, 2013). However, on another dimension of the Hofstede's national culture value, China exhibits lower uncertainty avoidance than the US and even more so compared to Japan. Thus, how Chinese firms’ policy choices would be different in relation to board size is an empirical research question.

Fourth, the Chinese market constitutes an interesting venue to study whether the empirical regularities about the influence of board size on corporate policy choices found for developed economies, can be established in emerging economies, where financial markets are much less developed, more growth opportunities are available and thus firms may have stronger incentives to pursue riskier strategies.

Our empirical analyses provide several interesting findings about the role played by board size in corporate risk-taking and firm policy decision-making for Chinese publicly traded companies. First, we report evidence that even in China's unique institutional and cultural context smaller boards still subsequently lead to a higher level of firm risk after controlling for leverage and investment decisions, consistent with the US findings. Despite a relatively low variation in board size due to the regulation restriction and the suspected state dominance on board appointment in China, the economic impact of board size on firm risk appears to be material. For a Chinese listed firm with mean-sized board, changing the board size from 9 (50 percentile) to 11 (75 percentile) would lower

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1 The China Securities Regulatory Commission (CSRC) has issued a series of guidelines in recent years to improve corporate governance mechanisms. For example, the CSRC issued the Code of Corporate Governance for Listed Companies in 2002, which sets forth the basic rules of conduct and moral standards for directors and executives of publicly traded companies, modeled after the best corporate governance practices in the UK and US. The code lays down a series of requirements for controlling shareholder behaviors as well as board composition and responsibilities, transparency, and information disclosure, etc.

2 China's corporate internal decision making entities consist of shareholders' general meeting, board and management. The Chinese Company Law (1994) empowers the shareholders' meeting to be the authority of the company, with the right to elect and change boards of directors and supervisors (Articles 38 and 100) and approve almost all strategic plans. However, the attendance of shareholders' meeting is often dominated by large controlling shareholders.

3 The responsibilities of Chinese boards are similar to their Japanese counterparts (see Nakano & Nguyen, 2012) but broader than the US corporate boards.

4 China's board governance structure appears similar to the German two-tier system, in which corporations are governed by a board of directors and a supervisory board, but the two systems are substantially different. The German two-tier board structure creates a management board that is responsible for managing the company and a supervisory board for supervising the executive directors. By comparison, China's board structure in practice is more like a muddled Anglo-Saxon one-tier type board, as both the board of directors and the supervisory board are appointed by and report to shareholders' general meetings (Allen, Qian, & Qian, 2005). The supervisory board comprises shareholder representatives and employee representatives, with the proportion of each group determined by the Company Charter, and has been criticized for performing its duties ineffectively (Conyon & H., 2011). What's more, the supervisory board in China is much smaller than that in the German system and has no authority to select or remove members of the board of directors.
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