



Determinants of corporate board structure in Taiwan



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ABSTRACT

This study examines the determinants of board structure for Taiwanese firms by reviewing their board elections, held between 1991 and 2009. The paper emphasizes three factors: the distinction between insider-affiliated and non-insider-affiliated outside directors based on family relationships, governmental agency theory-based regulations, and the firm's choice between agency and stewardship governance philosophy. Evidence has shown that the proportion of non-insider-affiliated outsiders on the board is sensitive to changes in firm and CEO characteristics, and to changes in government regulations. Government regulations significantly shape corporate boards, encouraging a smaller size, more outside directors, and fewer insider-affiliated outside directors. For firms adopting agency and stewardship theories as governance arrangement, the determinants of board structure are diverse. The board structure of principal–steward firms is less susceptible to changes in firm characteristics but more susceptible to CEO influence, and more responsive to government regulations.

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1. Introduction

Boards of directors play a central role in the corporate governance of publicly listed companies. Knowledge of factors that affect board structure, namely, board size and composition, is necessary to understand boards and their role in corporate governance. Previous studies by Hermalin and Weisbach (1998), Weisbach (1988), and Denis and Sarin (1999), and a survey article by Hermalin and Weisbach (2003) indicated that the influence of a firm's CEO or funders is an important factor in determining board structure. They found that tightly held firms, where funders are active and CEOs have large share ownership, tend to have insider-dominated boards. Professional directors, with small ownership stakes and outsider-dominated boards, are likely to appear in larger and older firms. Knowledge of the determinants of board structure has increased in recent years. Theoretical work, such as that of Raheja (2005), Adams and Ferreira (2007), and Harris and Raviv (2008), has emphasized the contracting roles of outside and inside directors and argued that board structure should be an optimal mix of directors based on the contracting environment of the firm. Boone, Field, Karpoff, and Raheja (2007), Coles, Daniel, and Naveen (2008), Guest (2008), Linck, Netter, and Yang (2008), and Lehn, Patro, and Zhao (2009) found that board size and board composition, represented by the proportion of outside directors on the board, are systematically related to firm characteristics identified by theoretical studies. The relevant characteristics include the firm's need of advice and access to resources, the tradeoff between benefits and costs of monitoring managers, and the power struggle between CEOs and outside directors.

Although recent studies have made considerable advances, their focus has been on companies in the US and the UK. Less is known about the trends and determinants of board structures in countries with diverse characteristics in the corporate sector, and in legal and regulatory systems. Examination of other countries would therefore provide a broader view of the factors that determine board structure. This study contributes to the literature by examining the determinants of board structure of a sample of Taiwanese electronic and information companies, for the period from 1991 to 2009. In addition to the hypotheses tested by the previous studies, this paper addresses three issues particular to the Taiwanese board structure, which could become the general concerns of future studies.

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First, Chinese family culture is an important factor when examining Taiwanese corporate boards. Both in typical family-controlled firms and in the firms without apparent family control, inside directors tend to invite family members to sit on the board as outside directors. The tradition of family solidarity and dedication strengthens the insiders' power in the process of decision making. Therefore, in addition to board size and the proportion of outsiders on the board, which have been the focus of previous studies, the current study emphasizes the proportion of insider-affiliated outsiders, defined as outside directors having family relationships with insider directors. Second, government regulations toward agency theory-based governance arrangements are a significant force that drives firms to restructure their boards to adopt a more efficient size, and to introduce more outsiders into the board. This factor reflects the role of legal and institutional systems in the adjustment of corporate board structures. Third, the choice of corporate governance arrangements is an endogenous decision of a firm. As an alternative to the agency theory, the stewardship theory, which focuses on the social and psychological relationships between the board and management structures, is an appropriate perspective from which to examine Taiwanese boards. Previous studies have noted that stewardship-based firms typically fuse incumbent board chair and CEO roles. This study distinguishes the leadership structure between dual CEO and non-dual CEO structures, to understand how the choice of a governance mechanism affects the determinants of board structure.

Although few studies in the literature have considered the subject, Yeh and Woidtke (2005) investigated board composition of Taiwanese firms, focusing on the perspective of controlling shareholders. They argued that a firm's board composition is determined by the controlling shareholders. If controlling shareholders are committed to a well-functioning board monitoring, they may select more members who are not affiliated to controllers into the board. In contrast, board members affiliated to controllers are likely to be selected when the controllers' entrenchment effects outweigh their incentive effects associated with cash-flow ownership. The contribution of the study by Yeh and Woidtke is noteworthy in that it focuses on the relationship between board composition and the controlling-minority structure, which is a pattern of firm control widely adopted in several East Asian countries (Bebchuk, Kraakman, & Triantis, 2000; Claessens, Djankov, & Lang, 2000; La Porta, Lopez-de-Silanes, & Shleifer, 1999). Rather than assuming that a board's composition is totally determined by the controlling shareholders' motivation and will, this study examines how economic and organizational determinants, which relate to the firm's advice and resource needs, benefits and costs of monitoring, and negotiation between CEOs and outside directors, affect board structure. Although this study approaches the problem from a distinctly theoretical background, it may be reconciled with the argument of Yeh and Woidtke. Three issues proposed above can be regarded as reflecting the functioning of the controlling-minority structure. The influence of controlling shareholders is embedded in the decision to select insider-affiliated outsiders for the board, in the response to changes of government regulations, and in the selection of the stewardship theory as the philosophy of governance arrangements.

The study sample is selected from electronic and information firms listed on the Taiwan Stock Exchange (TWSE) in 2009. By reviewing the annual reports of these firms, this research constructs a panel data set by tracking the data of board size and composition for the board elections of each sample firm, held between 1991 and 2009. The panel data set is thus unbalanced, in the sense that the firms in the sample may have board elections taking place in various years. This sampling procedure differs from that of previous studies, which include observations on board structure from annual data, two-year data, or three-year data, when the persistence of board structure is considered. By focusing on the time of board director elections, the relationships between changes in board size and composition and firm and CEO characteristics can be more accurately examined.

Both static and dynamic panel data models are specified to examine the determinants of board size, the proportion of outsiders on the board (either including or excluding insider-affiliated outsiders), and the proportion of insider-affiliated outsiders to total outsiders. For the estimation of the static panel model, we use Hausman and Taylor (1981) estimator for the random effects model to allow for the potential correlation between regressors and unobserved firm heterogeneity. The two-step GMM estimation developed by Arellano and Bond (1991), and Arellano and Bover (1995), is used to estimate the dynamic panel model. To solve the potential over-identification problem in the estimation, a principal components analysis, which can achieve data summarization and reduction, is employed for variable transformation. These estimation procedures are expected to provide a more robust analysis of board structure.

The paper is organized as follows. Section 2 briefly reviews recent studies on the determinants of board size and composition. Section 3 describes relevant issues when examining Taiwanese board structure, and discusses testable hypotheses. Sections 4 and 5 provide data and empirical models. Section 6 presents empirical results, and Section 7 concludes the paper.

2. The literature for the determinants of board structure

A multi-theory approach is adopted in the literature to examine the determinants of board structure. The discussions typically focus on the monitoring and advisory functions of boards and the influence of the CEO on the board. These arguments are rooted in various corporate governance theories, mainly the agency theory, the resource dependence theory, and the power perspective.

The agency theory, a dominant theory applied in corporate governance studies, is appropriate for conceptualizing the monitoring and controlling roles of directors. The monitoring function refers to the responsibility of directors to monitor the actions of agents – the managers – to protect the interests of principals – the shareholders. The board serves as the representative for shareholders and is the primary internal control mechanism in aligning the conflicting interests of shareholders and management (Fama & Jensen, 1983; Jensen & Meckling, 1976; Shleifer & Vishny, 1997).

The resource dependence theory (Dalton, Daily, Johnson, & Ellstrand, 1999; Hillman & Dalziel, 2003; Hillman, Cannella, & Paetzold, 2000; Johnson, Daily, & Ellstrand, 1996; Mizuchi, 1996; Parker, 2007; Ruigrok, Peck, & Keller, 2006) establishes a theoretical foundation for the role of directors in providing advice and resources. This theory suggests that board effectiveness is determined by the external resources that individual members are able to draw on for the benefit of the corporation. Directors reduce firm uncertainty by connecting the firm to the outside community. They provide advice and counsel, legitimacy, channels for communicating information between

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