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Supervisory board characteristics and accounting information quality: Evidence from China☆

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ABSTRACT

Using hand-collected data on the personal characteristics of supervisory board members, we study the relation between these characteristics and the accounting information quality of firms in China. Our results suggest that supervisors with an accounting or academic background, supervisor compensation, and female supervisors are consistent drivers of improvements in accounting information quality in China. Our conclusions are robust to earnings response coefficient and discretionary accrual approaches to measure accounting information quality. Chinese regulators and policy advisers can leverage our findings to improve the performance of supervisory boards in the two-tier corporate governance system in China.

1. Introduction

There are two main systems of corporate governance. The first is a unitary board system, in which the board of directors (BD) is charged to manage and monitor a firm. Usually, directors in such a system consist of senior executives as well as a group of independent directors. The United States and the United Kingdom are good examples of this system.

The second is a two-tier board system. In addition to a BD, a firm also has a supervisory board (SB), with a group of supervisors. Typically, executives cannot be supervisors. In this system, the BD is charged with managing the firm on a day-to-day basis while the SB serves the monitoring function. The two-tier board system is popular in Germany, France, and Japan. China has had a two-tier system since 1993. Unlike in Germany and other countries, the SB in China did not have the power to discipline poorly performing executives until late 2005. That is, the SB in China initially played only an advisory role and its role has gained importance in recent years.

The limited literature on the Chinese two-tier board governance system generally suggests that SBs are ineffective. Dahya, Karbhari, and Xiao (2002), in a series of supervisor interviews in China, summarize several qualitative reasons why SBs are ineffective. The reasons include SBs play only an advisory role in the corporate governance process, they lack power to discipline poorly performing executives, and supervisors have no financial and other incentives to serve as monitors. Recently, Jia, Ding, Li, and Wu (2009), in a study of enforcement actions by the China Security Regulatory Commission (CSRC), document that more severe sanctions are imposed upon firms with larger SBs. In addition, firms that face more severe enforcement actions have more frequent SB meetings. That is, a large SB or an SB with more frequent meetings does not help corporate governance.

Interestingly, the SB board literature in other countries suggests that SBs have value. For example, Tušek, Filipović, and Pokrovac (2009) document that SBs can improve the quality of financial reports. The SB literature, however, seldom examines the detailed

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characteristics of supervisors and how these relate to SB effectiveness. In the context of the BD literature, the effectiveness of a board depends partly on the characteristics of its members. For instance, Chen, Firth, Gao, and Rui (2006) document that BD characteristics are important factors in explaining fraud in China. Chan and Li (2008) report that independent directors with a financial background enhance firm value. Similarly, Hoitash (2011) finds that independent directors with social ties to management and serving on audit committees are able to improve a firm's financial reporting quality.[1] These studies, however, focus on independent director characteristics in a unitary board system. Few studies examine how supervisor characteristics in a two-tier board system relate to firm performance. Hence, we have no a priori reasons to suggest that the impact of supervisor characteristics is similar to those in unitary board studies. It is a research question.

Without a detailed examination of supervisor characteristics, the relative importance of these characteristics in contributing to SB performance is unclear. In addition, we concur with Dahya et al. (2002) that, if SBs are ineffective, we should examine how to improve their effectiveness in more detail. Thus, an examination of the characteristics of supervisors in a two-tier board system can provide useful information to investors, firms, and regulators.

The objective of this study is twofold. First, we examine the effectiveness of Chinese SBs in the context of accounting information quality. Specifically, we study the relation between individual supervisor characteristics and accounting information quality. Our study conducts a comprehensive analysis of the supervisor characteristics in the SB literature. Our findings add to the debate on the effectiveness of SBs in China. Second, we identify the underlying drivers of accounting information quality in the context of SBs. We contend that accounting information quality is the first step toward a good corporate governance system. Only good accounting information can lower the information asymmetry between a firm and its outsiders so that it is easier for stakeholders to evaluate the firm's financial performance. Accordingly, investors and regulators can draw on the findings of this study to reform the SB system in China.

The Chinese focus of our study offers two additional insights. First, unlike the literature in other two-tier board systems, the majority of the literature related to China reports that its SBs are ineffective. Thus, it is informative to identify drivers that can enhance SB effectiveness. Second, China's Company Law made important changes in late 2005 and empowered the monitoring role of SBs in 2006. Hence, by comparing the impact of SB characteristics on accounting information quality before and after 2006, we provide insight into the effectiveness of the regulation change on SB effectiveness.

Our findings suggest that supervisors with an accounting or academic background, supervisor compensation, and female supervisors are consistent drivers of improvements in accounting information quality in China. Our conclusions are robust to earnings response coefficient (ERC) and discretionary accrual (DA) approaches to measure accounting information quality. In addition, we find that China's new Company Law of 2005 had a positive impact on the effectiveness of SBs, a result that is consistent with those of Ding, Wu, Li, and Jia (2010). Chinese regulators and policy advisers can leverage our findings to improve the performance of SBs in the two-tier corporate governance system in China.

We organize the paper as follows. Section 2 presents the background and literature review. The data and research method are discussed in Section 3. Section 4 presents the results and discussions and Section 5 concludes the paper.

2. Background and literature review

2.1. Background of Chinese SBs

The economic reform in China in the early 1980s called for the need to raise capital for economic development. Thus, the Chinese government established stock markets in the early 1990s to facilitate capital formation. Subsequently, China introduced its Company Law in December 1993 to regulate publicly traded firms. One of the major provisions in the Company Law mandates a two-tier board governance system for industrial firms, that is, an SB with at least three members in addition to a BD. The members of the SB cannot be the directors of the BD or senior executives of the firm. The membership of an SB consists of shareholders and elected labor representatives. The SB has five duties: 1) to examine a firm's financial reports, 2) to ensure that the senior executives and the BD obey the laws and procedures of the firm, 3) to undertake corrective action when the behavior of senior executives and directors is detrimental to the firm, 4) to arrange shareholder meetings, and 5) to take on other duties as specified in the firm charter. The revised Company Law of December 1999 additionally required setting up SBs in 100% state-owned enterprises. Hence, the SB has become an integral part of the Chinese corporate governance system since 1999.

To improve the effectiveness of SBs in China, the CSRC made two major amendments in the Company Law in October 2005. First, the CSRC mandated that at least one-third of the SB's membership consist of elected labor representatives. Second, the SB now has the authority to dismiss senior executives and the right to file legal complaints against senior executives. The 2005 amendments of the Company Law empowered SBs in China. We contend that this SB empowerment has helped improve the effectiveness of SBs since 2006.

2.2. Literature review

Our paper is connected to two strands of literature. The first is about the effectiveness of an SB system in a global context and the second relates to the effectiveness of SBs in China. We discuss these below.

[1] Chen (2014) reports that the board structure of Taiwanese firms is made up of family-related, government connected, and governance stewardship philosophy directors. Yeh, Shu, and Chiang (2014) find that control rights, cash flow rights, and the control/cash flow deviation associated with controlling owners determine board composition. That is, besides director characteristics, other determinants also contribute to a board's effectiveness in a unitary board system.