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Connected board of directors: A blessing or a curse?

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ABSTRACT

This study attempts to identify the connection between the board of directors (BoD) and the controlling shareholder. We investigate how this connection affects the corporate governance practice and market performance of Hong Kong listed firms. Our results reveal that close connections between the BoD and the controlling shareholder have a negative effect on corporate governance practice. Our findings also indicate a lower market valuation for firms with a connected BoD. The evidence suggests that the market discounts the value of firms with a connected BoD. The evidence seems to reinforce the importance of the role of independent non-executive directors (INEDs) to enhance the independence of BoD.

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1. Introduction

Corporate governance is the system used to delineate the rights and responsibilities of the board, management, shareholders, and other stakeholders in a firm. In theory, good corporate governance should always be associated with lower agency cost that would result in higher returns to shareholders. Numerous studies investigate the relation between corporate governance and firm valuation.[1] Previous work has examined how ownership structure affects the quality of corporate governance practice.[2] However, few studies examine how the connection between the board of directors (BoD) and the controlling shareholder affects corporate governance practice and, in turn, firm valuation. Such studies are particularly important in Asia, with its family-dominated culture in the business sector. It is common in Asia that a firm's BoD is dominated by the directors who are connected to the controlling shareholder in several ways. For instance, these directors might be family members of the controlling shareholder. The question is whether the market cares about the connection of BoD with the controlling shareholder. This study aims to investigate how a connected BoD affects the firm's corporate governance practice and firm value.

This study uses a corporate governance index (CGI) based on the Principles of Corporate Governance by the Organization for Economic Co-operation and Development (OECD, 2004) to assess the overall corporate governance practice of Hong Kong listed firms from 2002 to 2008.[3] The CGI has been used extensively in the literature to examine the corporate governance practice of listed firms.[4] Our sample firms are assigned a CGI for each of the 5 years, representing almost 90% of the total market capitalization and almost 80% of the market turnover in the Hong Kong stock market.

We conduct this research in the Hong Kong market for two reasons. First, Hong Kong is a major world financial center. The Hong Kong stock market enjoys a well-developed financial infrastructure and regulatory supervision. Second, the ownership structure for most Hong Kong listed firms is dominated by families. Thus, the agency conflict between controlling shareholders and minority shareholders is a serious issue in Hong Kong market.

Our results show that a higher proportion of connected directors are associated with lower-quality corporate governance

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[1] See, for example, Gill (2001), Black (2001), Black et al. (2006), Durnev and Kim (2005), Dittmar and Mahrt-Smith (2007).

[2] See, for example, Johnson et al. (2000), Bae et al. (2002), Claessens et al. (2000), Bertrand et al. (2002) and Lemmon and Lins (2003).

[3] Specifically, the CGI data on Hong Kong listed firms are available for 2002, 2004, 2005, 2007, and 2008. The CGI data are derived from the rating projects sponsored by the *Hong Kong Institute of Directors*. Such projects had been conducted only for these 5 years.

[4] For example, Cheung et al. (2007) use this measure for Hong Kong listed firms. Cheung et al. (2008) use this measure for firms listed in China.

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practice. Such association is stronger for family-dominated firms. We further find that the proportion of connected directors adversely affects firm valuation. Our findings suggest that external investors tend to discount the value of firms with a BOD closely connected to their controlling shareholders.

This study contributes to the literature in several ways. First, our study provides evidence on how the connection between board members and the controlling shareholder affects a firm's corporate governance practice and firm valuation. Second, most extant studies on board structure focus on size, independence, and leadership. Our study adds to the literature by unveiling the influence of the directors' backgrounds and their relation to the controlling shareholder on corporate governance practice and firm valuation. Additionally, our findings provide implications for regulators who attempt to enhance the corporate governance of listed firms. Regulators should pay attention to the role of connected directors and how to enhance the role of independent non-executive directors (INEDs).

The rest of this paper is organized as follows. Section 2 briefly reviews the extant literature. Section 3 discusses the hypotheses. Section 4 describes the index construction. Section 5 introduces the sample and the methodologies. Section 6 presents the main empirical results, and Section 7 shows robustness tests. Section 8 concludes.

2. Literature review

Two streams of literature are related to this study. The first stream pertains to the relation between corporate governance practice and firm value. Several studies use board size as a proxy for corporate governance practice. Lipton and Lorsch (1992) reveal that if board size is too big, the board may be less effective. Directors may free ride among each other, and spend more time and resources communicating, negotiating, and compromising with one another during the process of decision-making. Yermack (1996) provides empirical evidence that firm value, measured as Tobin's Q, is negatively associated with board size.

Board composition is another widely discussed issue. As opposed to inside directors, outside directors have a duty to monitor managers and help reduce the agency problem. Outside directors are voted in by the shareholders to work on their behalf. Thus, firms with better performance have more outside directors on the board, as documented by Weisbach (1988). Rosenstein and Wyatt (1990) show that announcements of the appointment of outside directors are associated with increases in shareholder wealth. Kaplan and Minton (1994) show that outside directors can stabilize and modestly improve poor firm performance in Japanese firms. In contrast, several other researchers find a negative relation between firm value and the proportion of outside directors, possibly because of an inefficient selection process (Agrawal and Knoeber, 1996) or lack of time, expertise, or incentives for outside directors (Patton and Baker, 1987).

A number of studies examine the relation between overall corporate governance practice and firm market value in recent years. They employ an index to measure the overall performance of corporate governance. These widely used indexes are usually constructed by international institutions including the Organization for Economic Co-operation and Development (OECD), Credit Lyonnais Securities Asia (CLSA), Standard and Poor's, Investor Responsibility Research Center (IRRC), and the Institutional Shareholder Services (ISS).

Using IRRC data, Gompers et al. (2003) create a "Governance Index" (G-index) that consists of 24 provisions related to takeover defenses and shareholder rights. They show that firms with stronger shareholder rights have higher firm value, higher profitability, and lower capital expenditure. Unfortunately, their study has limited relevance to the Asian market where hostile takeovers rarely occur.

Brown and Caylor (2006) create a corporate governance index (Gov-Score) using ISS data. They find that firms with a higher Gov-Score (i.e., better corporate governance practice) yield higher returns on equity and firm value, as measured by Tobin's Q. Their findings are complemented by Bruno and Claessens (2007) who use ISS data to measure the relation among country regulatory regimes, corporate governance practice, and firm value.

Using CLSA index for a sample of firms from different countries, Klapper and Love (2004) demonstrate that the quality of corporate governance is positively related to operating performance, as measured by return on assets (ROA). Mitton (2004) finds that corporate governance is positively related to the dividend payout ratio; and Durnev and Kim (2005) report that firms with a strong corporate governance mechanism have higher value.

In Hong Kong, Cheung et al. (2007) develop a corporate governance index (CGI) based on the revised OECD's Principles of Corporate Governance (OECD, 2004). They find that Hong Kong listed firms with better corporate governance practices have higher firm value. However, applying the same CGI for the 100 largest China listed firms, Cheung et al. (2008) fail to find a positive relation between corporate governance and firm performance in China.

Another stream of related literature investigates how ownership structure affects a firm's corporate governance practice. Jensen and Meckling (1976) theorize a negative relation between managerial ownership and the pursuit of private benefits by managers who deviate from shareholder wealth maximization. In the case of low managerial ownership, firms can set up a strong board to monitor managers. The board is authorized to replace poorly performing managers to ensure that the firm is operating effectively and efficiently. Morck et al. (1988) find a curvilinear relation between firm value and managerial ownership stake in the US.

Unlike their counterparts in the US, most Asian firms are dominated by a family or a majority shareholder. To achieve control without investing a commensurate equity stake, the controlling shareholder usually holds the firm through a rather complicated structure, such as a cross-shareholding or a pyramidal structure, as documented by Claessens et al. (2000).

Faccio et al. (2001) report that the dividend ratio of firms with dominant shareholders is higher in Europe than in Asian countries. Their findings suggest that dominant shareholders are more likely to expropriate minority shareholders in Asian firms than in European ones. Based on Korean data, Joh (2003) finds that ownership concentration is positively associated with accounting performance, but this positive relation is inversed in the presence of a divergence between cash flow and voting rights.

3. Hypotheses development

The BoD is viewed as the most important internal control mechanism responsible for disciplining the actions of insiders (Fama and Jensen, 1983)). To a great extent, board structure determines the effectiveness of the BoD in monitoring the firm's insiders. Board independence is critical to maintaining a good system of corporate governance and minimizing conflicts of interest between the minority and majority shareholders. However, most Asian firms are controlled by a majority shareholder who is able to appoint board directors as they want. To represent their interests, controlling shareholders are inclined to appoint directors who stand on the same side with them, for example, their family members. These appointed directors obviously have close connections with the

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