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Do independent directors play a political role? Evidence from independent directors' death events

Qing Ye^{a,b}, Zengquan Li^{c,*}^a Center for Accounting, Finance and Institutions, Sun Yat-sen University, China^b Sun Yat-sen Business School, Sun Yat-sen University, China^c School of Accountancy and The Institute of Accounting and Finance, Shanghai University of Finance and Economics, China

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ABSTRACT

We propose that independent directors are likely to play a political role in an institutional setting featuring weak investor protection and strong government intervention. Using Chinese data for 2001–2014, we investigate whether the stock price reaction to an independent director's death is related to his or her political connection. We find a stronger negative reaction to the death announcements of politically connected than politically unconnected independent directors. The magnitude of the reaction is positively related to directors' political rank, and cannot be offset by their firms' political capital. However, we document no evidence of politically connected independent directors exhibiting superior monitoring or consulting performance. Additional analyses show that firms are more inclined to appoint a politically connected independent director as a successor if his or her predecessor also had political connections. Our study broadens scholarly understanding of independent directors' role in a non-Anglo-American setting.

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1. Introduction

Independent directors are considered to constitute an important corporate governance mechanism by academics, practitioners and policymakers alike. The traditional view is that they enhance firm value by playing a monitoring or consulting role, although empirical tests do not unanimously support that view, partly due to the endogeneity problem (Adams et al., 2010). Another view is that independent directors are little more than window dressing, offering little real value, particularly when they fall into the vortex of public opinion during

* Corresponding author.

E-mail address: zqli@mail.shufe.edu.cn (Z. Li).

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corporate scandals. Hence, the issue of whether independent directors can play a role, and if so what role they play, is by no means settled. Further investigation is needed.

Scholars have increasingly begun to recognize the importance of the institutional environment in shaping the role of independent directors¹ (Liu et al., 2012, 2015). As firms face different constraints and opportunities in different institutional settings, the roles that they need independent directors to play and the roles that such directors can play are also likely to differ across settings. However, the extant literature focuses narrowly on independent directors' monitoring and consulting role in the context of developed markets. Little attention has been paid to their role in emerging markets, even though the institutional characteristics of those markets are likely to shape that role in significant ways. In this paper, we fill this research gap by proposing and empirically testing an alternative view. We posit that in addition to their monitoring and consulting role, independent directors can also play a political role in China, an emerging market setting characterized by weak investor protection and strong government intervention, and that firms in China need them to play such a role.

China offers weak legal protection for investors. To gain private benefits of control, the largest shareholders in a firm are often able to manipulate the selection process of independent director candidates and dismiss those incumbent who are "unfriendly" and thus likely to monitor them strictly, thereby impeding the monitoring role of independent directors (Liu et al., 2013; Tang et al., 2010). China is also characterized by strong government intervention, which means that firms' business strategies are severely affected by frequent policy changes and political disturbances, thereby weakening the consulting role of independent directors. At the same time, the regulatory power underscoring government intervention creates strong demand for rent-seeking. Independent directors with political connections can build a bridge for communication between firms and politicians, thereby helping firms to avoid policy risks and gain regulatory rent, through which they can play a crucial political role. In this context, a firm is likely to view politically connected independent directors primarily as a rent-seeking tool, with their potential monitoring or consulting role having little relevance.

To mitigate concern about the potential endogeneity problem, we empirically test the foregoing proposition by considering independent directors' death events from 2001 to 2014. Using this quasi-natural experiment, we investigate two issues. First, we compare the stock price reactions to the death announcements of politically connected and politically unconnected independent directors, allowing us to determine whether there is a political role that is restricted to the former. Second, we investigate whether firms are more inclined to appoint a politically connected independent director if his or her predecessor also had political connections. The China Securities Regulatory Commission (CSRC) requires that the proportion of independent directors on a board cannot be less than one-third, and most firms thus have to appoint a new such director to meet this regulatory requirement in the event of a director's death, allowing us to confirm firms' need for independent directors to play a political role.

The empirical results reveal a stronger negative stock price reaction to the death announcements of politically connected independent directors than to those of their politically unconnected counterparts. Further, the magnitude of the negative market reaction is positively related to the deceased director's political rank and cannot be offset by his or her firm's political capital, regardless of whether that capital takes the form of state-owned property rights or chairperson or CEO political connections. However, we document no evidence to indicate that politically connected independent directors perform better in their monitoring or consulting roles than their politically unconnected counterparts. Finally, in our test of the selection of successors, we find that firms are more inclined to appoint a new politically connected independent director if his or her predecessor had political connections, thus suggesting that politically connected independent directors are not randomly distributed and that firms need such directors to play a political role and actively select those capable of doing so.

This study contributes to the literature in several respects. First, it broadens the traditional perspective on the roles of independent directors. Most previous research focuses on their monitoring and consulting role, whereas this paper proposes and tests their political role by taking into account distinct features of China's institutional environment. Our findings emphasize the need for researchers to pay closer attention to the char-

¹ Liu et al. (2012) document the consulting role played by independent directors with a banking background in China, an institutional setting featuring financial repression. Liu et al. (2015) investigate the consulting role of nonlocal independent directors in nonlocal merger and acquisition activity in the context of a Chinese setting characterized by local protectionism.

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