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Are academic independent directors punished more severely when they engage in violations?☆

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ABSTRACT

We use a sample of Chinese A-share listed companies from 2003 to 2013 to explore the reputation damage and overflow effect of academic independent directors who have received supervisory punishment. We find that when companies violate information disclosure rules, the market punishes academic independent directors more severely than nonacademic independent directors for these violations. Furthermore, companies employing punished academic directors face greater declines in their stock price than companies employing punished nonacademic independent directors during a relatively short window before or after the punishment is announced. The punishment of academic independent directors influences the employment of other scholars in the same field and results in a negative overflow effect. This study provides evidence of the market's differential reactions to independent directors with different backgrounds; the findings reflect the double-edged sword of one individual's reputation on organizations.
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1. Introduction

Independent directors play an important role in modern corporate governance, helping balance power within firms and providing supervision. In China, 43.51% of independent directors are scholars from universities, party schools, research institutes or other public institutions. Mastery of professional knowledge and concern for their reputation are two important ways in which academic independent directors differ from

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other independent directors. With respect to professional background, 86.93% of academic independent directors are professors and 2.52% of them are members of either the Chinese Academy of Sciences or the Chinese Academy of Engineering. Generally, there is a tradition of respecting teachers and valuing education in China. Because of their broad recognition as intellectuals, academic independent directors have a positive social image and wide acceptance. When prominent scholars become involved in management, development is promoted and decision making is facilitated. They are also important invisible assets for corporations. That is, when these famous independent directors serve as image spokespersons for corporations, investors trust these listed companies more.[1] As a consequence, academic independent directors will care more than nonacademic independent directors about the possible negative effects on their careers of any negative behavior.

One important way in which an academic independent director's reputation may be damaged is when they receive supervisory punishment due to their companies' misconduct. Some reports suggest that between 2003 and 2013, 458 independent directors were punished by the China Securities Regulatory Commission (CSRC) or stock exchanges because of violations of information disclosure rules; 36.03% of these were academics. Xin et al. (2013) find that the number of academic directorships declined after these directors were punished. The decline in numbers is perhaps not symbolic of reputation punishment; it may simply be a consequence of risk aversion. Studies show that during the relatively short window after a punishment is announced, the stock prices of other companies that the independent directors who are being punished had worked for do not fall sharply. When the market punishes independent directors, academic independent directors may be treated differently because of their high reputation and the market's greater expectations. Such differences may occur in several ways; for example, the market may react more negatively, the stock price of other companies that employ academic directors may fall more sharply, or the punishment of academic directors may generate overflow effects to other scholars at the same universities.

Our analysis of a sample of Chinese A-share listed companies from 2003 to 2013 has two important conclusions. (1) The market punishes academic independent directors more severely for their violations. Specifically, when companies violate information disclosure rules and independent directors are punished by the China Securities Regulatory Commission or stock exchanges for failing to fulfill their executive duties, the market often reacts more negatively to those companies which have academic independent directors. Furthermore, companies that employ punished academic directors face greater declines in their stock price than companies that employ punished nonacademic independent directors, during a relatively short window just before or after the punishment is announced. (2) To some extent, the punishment of academic independent directors influences the employment of other scholars in the same field and results in a negative overflow effect. These conclusions are practically significant for both participants in the capital market and for corporate management. This research helps capital market participants identify companies with severe reputation punishment so that they can adjust their portfolios and properly reduce investment losses. With this knowledge, management can both enjoy the benefit of employing well-known scholars as independent directors and avoid the possible negative effects of these directors' improper behavior.

This study makes the following contributions. First, the existing research on independent directors' backgrounds focuses on resource support. For example, independent directors with commercial bank backgrounds may dramatically increase the total debt of a company (Booth and Deli, 1999; Burak et al., 2008; Liu et al., 2012), whereas independent directors with investment bank backgrounds help companies issue more bonds (Burak et al., 2008). Independent directors with academic backgrounds promote the entrance and absorption of external knowledge spillover (Audretsch and Lehmann, 2006). However, few studies have explored the "reputation punishment" associated with independent directors with different backgrounds. Therefore, we explore the concept of reputation punishment and the overflow effect on academic independent directors caused by information disclosure violations by academic independent directors. Our aim was to deepen the knowledge of the economic consequences of hiring independent directors with different backgrounds. Second, previous studies suggest that the extent of the market's reaction to corporate violations is significantly related to the type of violation (Wu and Gao, 2002) and to the transparency and severity of the punishment (Hu and

[1] Quoted from "Professors have become main power of independent directors, while reputation is a double-edged sword" (In Chinese) http://news.ifeng.com/gundong/detail_2011_05/05/6171735_0.shtml?_from_ralated.

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