Board Governance, Firm Performance, and the Influence of the Cultural Backgrounds of Directors: Evidence from Hong Kong Listed Companies

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by

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ABSTRACT

Since the 2008 financial tsunami, calls for improving corporate governance have become widespread. In response to these worldwide concerns, regulators in Hong Kong have reformed board governance mechanisms according to Anglo-American practices. This reform was also influenced by Western agency theory, which typically predicts a positive relationship between board governance and firm performance. However, the equivocal findings reported in relevant literature have suggested that further research is necessary. This study examined the relationship between board governance and market-based performance in an East Asian context, exploring the interaction effects among the cultural backgrounds of directors. The 5 investigated board governance measures were board size, board independence, chief executive officer (CEO) duality, financial expertise, and gender diversity. Firm performance and Western cultural background were proxied by the market value to book value ratio (MB) and fraction of Western directors, respectively.

Panel data on 246 large firms listed on the main board of the Hong Kong Stock Exchange in 2008–2010 were subjected to fixed-effects regression. Case studies of two listed companies were conducted to triangulate the quantitative results with qualitative data and to illustrate and elucidate certain quantitative findings. In contrast with the dominant view, which suggests an inverse relationship between board size and firm performance, the current results indicated a nonlinear and inverted-U-shaped relationship. Although a large board provides additional resources to firms, beyond a certain threshold, it increases the agency costs and offsets the advantages of additional directorships, resulting in diminishing returns. Financial expertise positively affected the MB, indicating the benefits of having accounting
experts on boards. CEO duality was negatively associated with the MB, indicating the advantages of separating the roles of CEO and chairperson. In addition, board independence and gender diversity exhibited no significant relationship with firm performance after control for potentially omitted variables was implemented.

Furthermore, the fraction of Western directors on the board negatively moderated the board size effect. This result suggested that Western cultural representation is likely to aggravate agency problems in an individualistic cultural context, potentially influencing the degree of the agency effect. Agency costs and disadvantages are greater among boards with a high fraction of Western directors than among boards with a low fraction of Western directors, thereby reducing the benefits of a large board. However, the fraction of Western directors did not significantly interact with other board governance variables. Finally, the fraction of Western directors positively affected firm performance, supporting arguments in favor of ethnic diversity.

A primary contribution of this study is evidence indicating that board size positively affects firm performance. This board size effect exhibits diminishing returns and is contingent on the cultural backgrounds of directors. The results revealed that the resource dependence and agency theories are relevant and complementary in analyses of board governance effects in an East Asian context. Regarding implications, policymakers should focus on determining the optimal board sizes for various listed companies. To ensure that they possess sufficient expertise and resources, listed companies should focus on appointing additional accounting experts to their boards and choosing appropriate board sizes after considering the negative moderating effect of the fraction of Western directors. Listed companies
should also separate the roles of CEO and board chairperson. However, additional research and theoretical work are required to elucidate the effectiveness of board independence and gender diversity.

Keywords: Board Governance, Board Size, Board Independence, Chief Executive Officer (CEO) Duality, Financial Expertise, Gender Diversity, Cultural Background of Directors.