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Is There an Expectations Gap in the Roles of Independent Directors? An Explorative Study of Listed Chinese Companies

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Abstract: This paper investigates whether an expectations gap exists in the control, strategic and resource provision roles that independent directors play in the corporate governance of listed Chinese firms and the factors that affect their performance of these roles. For this purpose, we interviewed Chinese executive directors, independent directors, institutional investors, and stock exchange regulators. We find a performance gap, but no reasonableness gap with respect to the control and strategic roles. The results suggest that the performance gap may be attributed to such factors as the ill-defined roles, independent directors' limited amount of time commitment and their lack of competence and objectivity. Interestingly, there is disagreement over the protection of minority interest as the objective of the control role. We find no consensus on the desirability, reasonableness and effectiveness of independent directors' resource provision role, perhaps because of a pejorative interpretation of this role as an exercise of Guanxi.

Keywords: China, Corporate Governance; Independent Directors; Control; Strategic Role; Resource Provision

1. Introduction

Theories suggest that independent directors (IDs)¹ can play three corporate governance roles: control, strategy and resource provision. This paper investigates the desirability, reasonableness and effectiveness of these roles and the factors that affect the performance of the roles. Specifically, we attempt to address the following research questions:

RQ1. What roles should IDs be expected to play?

RQ2. Under the current circumstances, is it reasonable to expect IDs to fulfil those roles?

RQ3. Do IDs play their reasonable roles effectively?

RQ4. What factors facilitate or impede IDs in the execution of their roles?

Answering these questions enables us to assess whether an expectations gap exists and if so, what factors contribute to it. Given that IDs have been designed as a formal corporate governance mechanism, it is important to identify expectations gaps relating to their roles and find remedies to address them. The frequent occurrence of large corporate failures in recent years suggests the ineffectiveness of IDs. This fact reinforces the importance of answering our research questions.

¹ The term ‘non-executive’ directors (NEDs) is commonly used in the UK in comparison to ‘outside’ and ‘independent’ directors used in the US and China respectively. For consistency, we use the term ‘independent directors’.

Many studies have examined the relationship between characteristics of IDs and corporate financial performance. This literature assumes that IDs help improve financial performance, but it has produced mixed results (e.g., Pearce and Zahra, 1991; Ezzamel and Watson, 1993; Peng, 2004; Firth et al., 2006). A finding of no performance effect may be used to indicate the existence of a performance gap, but such research findings are uninformative for our purposes as they do not pinpoint which roles of IDs are unfulfilled, and how and why they are unfulfilled. As a result, if there were a performance gap, they would be unable to reveal its nature and how it could be addressed.

This suggests a genuine need for directly examining the desirability, reasonableness and effectiveness of IDs' roles. Unfortunately, we can only identify a few prior studies. Reay (2004) reports that only 41 percent of British institutional investors consider IDs to play an effective watchdog role while all of them consider this role to be important. However, he reports no information on other roles played by IDs or the perceptions of other parties (e.g., IDs). Hooghiemstra and Van Manen (2004) undertake a survey of over 1,000 IDs, employee representatives and institutional investors in the Netherlands. They find no gaps on the division of duties between executives and IDs. However, they find expectations gaps on stakeholders' satisfaction with the current functioning of IDs, their roles concerning directors' remunerations and the interests they should serve. While these two pioneering studies provide some interesting insights, they do not distinguish *reasonableness gap* (between what IDs are expected to achieve and what they can be reasonably expected

to achieve) from *performance gap* (between what IDs can be reasonably expected to achieve and perceived actual achievements). Therefore, the implications of their findings are ambiguous. Brennan (2006) does distinguish reasonableness gap from performance gap and identifies the contributing factors, but the research concerns board directors in general, rather than IDs and is based on a literature review only. Moreover, as all these studies focus on developed countries, it remains to be evaluated whether their findings are applicable to transitional economies. In short, the literature on expectations gaps with regard to IDs' roles is extremely underdeveloped.

Our study thus is intended to complement the above studies of IDs' performance effects, and to enrich the literature that directly investigates expectations gaps relating to IDs' roles.² Unlike prior studies that focus on developed economies, we address our research questions in the context of China. As China has become one of the largest economies and recipients of foreign direct investments in the world, it is important to understand how its corporations are governed and how investors' stakes are protected. China has adopted a gradual and experimental approach to political and economic reform and thus is apparently different not only from developed economies, but also from other 'transition' economies which adopted a "Big Bang" reform approach. This gives its corporate governance system quite specific and complex

² In addition, our topic has not been directly addressed by, although it closely relates to, two groups of previous studies published in the British Journal of Management: (1) the role of IDs in improving board effectiveness (e.g., Roberts et al., 2005; Huse, 2005; Minichilli et al., 2009) and (2) the effectiveness of corporate governance mechanisms in China, e.g., Xiao et al. (2004) on Supervisory Boards and Yuan et al. (2009) on financial institutions.

characteristics. While the available evidence on the performance effects of IDs is limited and mixed, numerous large corporate scandals have been exposed implying that IDs have played a limited role (Chen et al., 2010).

We undertook personal interviews with IDs, executive directors (EDs), institutional investors (IIs) and stock exchange regulators (RLs) in China. From these interviews, we find that control and strategic roles are recognized as desirable by all four groups, and there may be a performance gap, but no reasonableness gap, in the two roles. We also discover that the desirability, reasonableness and effectiveness of IDs' resource provision role are indeterminate, largely because the role is interpreted in a pejorative sense (i.e., the exercise of 'Guanxi').

We believe our study is the first to make such discoveries in the Chinese context. Moreover, unlike prior studies, our findings have greater clarity because they are related to specific roles (the control, strategic and resource roles) IDs play and specific types of expectations gap (a reasonableness gap or a performance gap). As a result, our findings can potentially be used to generate more specific policy and research implications.

The remainder of the paper is organised as follows. Section 2 critically reviews theories and empirical studies of the roles of IDs. Section 3 introduces the background of Chinese corporate governance and China-related studies. Section 4 discusses our research methods. Section 5 focuses on data analysis. Section 6 concludes.

2. Theory and Literature

To provide a basis on which to assess their desirability, reasonableness and effectiveness, this section presents a critical review of the main theoretical origins of the three roles ascribed to IDs and their empirical underpinnings.

2.1 The control role

Agency theory is the main theoretical source for the control role. Its proponents expect corporate boards to act as a control mechanism to reduce the potential divergence of interests between management and shareholders (the Type I agency problem) (Fama, 1980) and the conflicts between controlling shareholders and minority shareholders (Type II agency problem) (Villalonga and Amit, 2006). Due to their supposed independence and objectivity, IDs are expected to help render the board's control more effective by providing an important check and balance to the power of the executives (Fama and Jensen, 1983; Williamson, 1984) and by constraining large shareholders from expropriating minority shareholders (Johnson et al., 1996).

However, empirical evidence on the desirability and effectiveness of IDs' control role are mixed. Much research relies on the proportion of IDs as an indicator of board independence, and has focused on the link between board composition and financial performance. Some of these studies report a positive relationship between them (e.g., Ezzamel and Watson, 1993; Pearce and Zahra, 1991), while others find no such relationship (e.g., Hermalin and Weisbach, 2003; Dalton and Daily, 1998).

The ambiguity of the existing evidence raises the question of whether this role has been overemphasised (Daily et al., 2003; Roberts et al., 2005) and serves as a call for further study of the desirability of ID's control role and inner-workings.

2.2 The strategic role

Agency, stewardship and resource dependence theories agree on the boards' strategic role although each has a particular emphasis. Agency theory pays specific attention to the board's involvement in and contribution to the development of the firm's strategy and the effective control of the chosen strategy (Zahra and Pearce, 1989). By comparison, stewardship theory contends that the strategic role contributes to the board's stewardship and resource based theory takes the view that larger and more diversified boards strengthen the links between the organization and its environment as well as securing critical resources such as prestige and legitimacy (Stiles and Taylor, 2001).

There is little empirical evidence on IDs' strategic role. Nevertheless, Carpenter and Westphal (2001) find that outside directors with network ties to strategically related companies contribute positively to the strategic decision making process. In contrast, Chen et al. (2009) find that Australian boards with more outside directors are not associated with corporate decisions on product and/or geographic diversification.

2.3 The resource provision role

The desirability of a resource provision role is mainly supported by resource dependence theory which argues that the directors' role, particularly that of IDs, is regarded as providing access to scarce resources such as external finance or other critical resources (Mizruchi and Stearns, 1994; Hillman et al., 2000), information on competitors and industry (Lang and Lockhart, 1990), advice/counsel to management (Westphal and Zajac, 1995) and enhanced reputation/legitimacy (Daily and Schwenk, 1996). However, while empirical evidence supports the argument that board composition reflects the external environment of a company and that companies bring in more resource-rich IDs to their boards when the level of uncertainty in the external environment is higher (Hillman et al., 2000), some commentators claim that such a role remains unmeasured and unverified (Donaldson, 1995).

In summary, even though IDs are theoretically expected to play control, strategic and resource provision roles, empirical studies present mixed results on their effectiveness. Furthermore, we know little about whether an overall consensus exists regarding IDs' roles amongst the relevant parties (e.g., IDs, EDs, IIs and regulators).

3. Corporate governance and the role of IDs in China

In the early 1990s, Shanghai and Shenzhen stock exchanges were established. An unusual characteristic of the Chinese stock markets was that about 90 percent of the companies were restructured state-owned enterprises (SOEs) and that the state owned

about two-thirds of their shares (Qiang, 2003).³ This has generated a conflict between the government, pursuing non-economic objectives, and private investors, intending to maximise their returns (Chen and Lin, 2007).

In China, corporate control of a listed company is used as a means of raising external funds (Cai and Chen, 2004) while in a mature capital market it is often seen as an ultimate means of mitigating agency problems. Moreover, legal protection of private shareholders is weak (Lu, 2009). The quality of the law and the effectiveness of law enforcement in China is below the average for 'transition' economies (Pistor and Xu, 2005). Law enforcement is ineffective because courts have restricted investor law suits and the China Securities Regulatory Commission (CSRC) has contradictory objectives of fostering the development of a capital market while protecting ailing SOEs (Clarke, 2003). Furthermore, external auditing in China is improving but still weak because domestic audit firms only emerged in the 1980s and lack independence from government while international audit firms do not provide higher quality audits than domestic ones because of low legal risk in China (Liu and Zhou, 2007).

In the absence of effective external mechanisms, internal mechanisms become particularly important for shareholders to monitor corporate activities. Under Chinese Corporate Law, all listed companies have a two-tier board structure where the BoD is regarded as a 'decision-making' unit and the Supervisory Board (SB) as a mechanism

³ State-controlled shares used to be untradable, but the CSRC launched a reform to enable all shares to be publicly tradable in April 2005 (for more details, see Wei and Xiao, 2009).

that monitors the activities of the BoDs. The appointment of IDs in listed companies only became a legal requirement when Corporate Law was revised in 2005. However, before this requirement, the CSRC had formally introduced IDs to the BoDs by stipulating the Code of Corporate Governance (CSRC, 2002) and the Guidelines for Introducing Independent Directors to the Board of Directors (CSRC, 2001). The Code refers to the duties of IDs generally as “good faith and due diligence towards the listed company and all the shareholders”, but specifically states that IDs “shall be especially concerned with preventing the interests of minority shareholders from being infringed” (CSRC, 2002: Chapter 3 (5) 50). The Code also requires IDs to chair the board’s sub-committees and monitor EDs and the board procedures. Meanwhile the Guidelines requires IDs to express their opinions on such material events as appointment/replacement of directors and senior managers and debt finance that exceeds RMB ¥3 million or 5 percent of the company’s net assets. In addition, IDs are awarded “special powers”: (i) to approve major related party transactions before BoD discussion, (ii) to propose to the board to call interim shareholders’ and board meetings and (iii) to propose the appointment or removal of the company’s auditors.

The acknowledged ineffectiveness of the SB’s monitoring role (e.g., Xiao et al., 2004; Li and Tang, 2009) has led to a high expectation of IDs’ roles in corporate governance. However, it remains unclear whether Chinese IDs can play, or actually play, their defined roles effectively. Some studies provide positive evidence. For instance, Peng (2004) finds that IDs improves sales growth but not return on equity. More recently, Chen and Lin (2007) find a smaller proportion of IDs in firms

experiencing frauds than in non-fraud firms. Several studies suggest that resource dependence may have a heightened role for IDs because of the Chinese cultural propensity to rely on relationships (*guanxi*) (Peng, 2003, and 2004; Au et al., 2000; Park and Luo, 2001). In contrast, other studies question the effectiveness of IDs. Liu and Lu (2004) find that some IDs were friends of EDs and given the prevalent *guanxi* culture, it is difficult for IDs to vote against their ED friends. The eruption of a series of highly publicised corporate scandals supports these observations (Chen et al., 2010).

4. Research methods

We planned to interview ten EDs and ten IDs from ten listed firms, ten IIs who held ownership shares of listed firms and RLs (officials at the Shenzhen and Shanghai Stock Exchanges). These groups were chosen to enable us to compare the opinions of EDs versus IDs, and outsiders (IIs, regulators) versus insiders (IDs and EDs).

We chose to use in-depth interviews, rather than a questionnaire survey, as they would allow us to probe into sensitive issues and gain deep and rich insights. Also, the participants could elaborate and clarify ambiguous responses while maintaining the focus of the discussion on key issues (Nachmias and Nachmias, 1996). More importantly, EDs and IDs were unlikely to complete questionnaires on sensitive issues.

We considered the following factors in selecting the sample companies and interviewees. First and foremost was accessibility. This proved very difficult but our

personal and professional contacts in China provided a pool of potential companies we could access. Second, we selected companies from different regions and industries, and of different listing age and size, to obtain balanced views. Hence, our sample companies were drawn from Beijing (North China, the political centre), Shanghai (Southeast China, a financial and commercial centre), Guangdong (South, a manufacturing centre) and Hunan (Central China, relatively less developed). They represented firms in IT, manufacturing, pharmaceutical, transport, real estate and commercial industries. Their sizes (total assets) ranged from RMB ¥1 billion to over RMB ¥40 billion. Their listing ages also varied from seven to over 17 years. Third, to increase the richness, variety and reliability of the interviews, we obtained nine pairs of IDs and EDs from nine companies. Fourth, our interviewees had different backgrounds. The IDs represented three of the most popular sources: accounting/tax professionals or professors, industry specialists and senior managers of other companies; the EDs included CEOs, Deputy CEOs and a Company Secretary; and IIs were drawn from securities companies, funds and investment consulting companies.

A combination of the above factors led us to conduct a total of 30 interviews during July-August 2006 and June-July 2007. These included interviews with ten IDs, ten EDs, eight IIs and two stock exchange officials (see Table 1). Despite our effort to take into various factors into consideration, our sample was essentially a convenience, rather than a random sample. It is considered difficult to generalise statistical findings from a convenience sample to the population because the results may be biased. For

example, one noticeable bias in our sample was the absence of lawyer IDs.⁴ However, most behavioural and social science studies use convenience samples and they are considered particularly appropriate and useful in case of an explorative study and when it is impractical to obtain a random sample (Herek, 2010; Randall and Gibson, 1990). Our study is explorative as little prior study has been done and it was extremely difficult to obtain a random sample of interviewees because of the access problem. The weaknesses of the convenience sample hopefully are more than compensated by the richness and depth of our interview data.

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Insert Table 1 About Here

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We failed to gain access to an ED in Company 5 and an ID in Company 11, so the data from the interviews with ID5 and ED11 has been removed from data analysis. We stopped interviewing more IIs after we had done eight of them, because saturation had already become evident (Glaser and Strauss, 1967).

Prior to the interviews, we developed a list of semi-structured questions related to all three theoretical roles and our four research questions, as shown in Appendix 1. These were used to guide the interview process and to maintain broad consistencies between interviews. The meaning of each concept was discussed with

⁴ We did try hard, but failed to arrange an interview with a lawyer ID, after several postponements by him.

the interviewees at the beginning of the interviews. Our literature review reveals that the ID's roles are multi-dimensional. For example, IDs' expertise contributing to strategic decision-making involves strategic and resource roles. Huse (2005) defines the IDs' roles as control and service, and includes behaviour, output and strategic control in the former, and advice, networking, communication and strategic participation in the latter. This model is further developed by Minichilli et al. (2009). The present study applies Huse's model regarding the control role, but focuses the strategic role on strategic participation, including provision of advice on strategic issues while focusing the resource provision role on networking, communication and other resource-based services. This classification was consistently used throughout the interviews and has been applied in our data analysis.

In order to obtain a quantitative measure of whether there is a reasonableness or performance gap with respect to a corporate governance role, the interviewees were asked to score on whether the role is considered to be reasonable or effective using a five point scale (1=very unreasonable/very ineffective, 2=unreasonable/ineffective, 3=neutral, 4=reasonable/effective, 5=very reasonable/very effective).

Most interviews were conducted face to face, except that one ID and one regulator were interviewed by phone. Each interview lasted about one hour and was recorded, except for one II and two IDs who rejected recording, but allowed us to take notes. The interviews were transcribed in Chinese and then translated into English. A seven-stage approach, suggested by Easterby-Smith et al. (1991), was adopted to sift

through and process the interview data: case familiarisation, reflection on contents, conceptualisation, cataloguing of concepts, recoding, linking, and re-evaluation. During these stages the responses were analysed to identify common themes which were then compared to the researchers' own prior expectations and extant literature. The approach is iterative in that data and analysis were revisited on several occasions over an extended period of time.

5. Data Analysis

A summary of the views of EDs, IDs and IIs on the three roles are shown in Tables 2, 3 and 4, respectively. Integrating the concept of expectations gap, introduced in Section 1, and the research questions, a seven-scenario data analysis framework is developed as shown in Fig.1. A reasonableness gap exists when a role is identified as desirable (yes to RQ1), but it is not reasonable to expect an ID to play such a role under current circumstances (no to RQ2), shown as scenario 2 (S2). A performance gap is identified when it is reasonable to expect an ID to play a given role (yes to RQ2), but this role has not been played effectively (no to RQ3), shown as S7. In addition, S3 implies no reasonableness gap and S5 and S6 imply no performance gap, while S1 and S4 are unlikely to happen. The responses on RQ4 and the opinions from the two regulators are integrated into the analysis of the causes of expectations gaps. We follow this framework and analyse each role in turn.

The summarized views and quotations from the interviews are used in the analysis as empirical evidence. In addition, three statistical tests are undertaken to

examine the existence of the expectations gaps: the one sample Chi-square test of whether the different types of opinion are statistically different; the Kruskal-Wallis test undertaken to investigate whether the opinions of the three groups of interviewees are statistically different; and the Wilcoxon Signed Rank test used to compare the opinions of the paired IDs and EDs.

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Insert Fig.1 about here

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5.1 The control role

5.1.1 Is the control role desirable?

Section 1 of Table 2 shows that in total 23 out of 26 interviewees agreed that they would expect IDs to play a control role. A statistically significant Chi-square test ($X^2 = 15.385$, Sig.=0.000) indicates a high consensus on the desirability of the control role. Consistently, the Kruskal-Wallis and Wilcoxon tests do not show that the opinions among the three groups and between the paired IDs and EDs are significantly different.

This consensus is consistent with the regulators' emphasis on the control role (CSRC, 2001; 2002). Many interviewees also provided further comments on this role. For example, RL1 stated: "*This is the main role an ID is expected to play*". Some interviewees valued the existence of IDs as "*a voice from the outside*" (e.g., ED2, ID2), and expected that "*IDs could help reduce risk by restricting diversified*

investment and increasing information transparency on related party transactions”

(e.g., II6, ID4, ID6).

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Insert Table 2 about here

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Despite the above consensus, the interviews revealed mixed views over the objectives of exercising control. The Code (CSRC, 2002) emphasizes the interests of minority shareholders, but this focus was frequently questioned by the interviewees.

Seven out of nine IDs stated that they should represent the interests of the company and ensure compliance with the regulatory guidelines. *“I have never thought that IDs’ role is to protect small shareholders. I am here, as a director, to represent the interests of all shareholders”*, ID4 said. This echoes the finding by NG and Roberts (2007) that IDs help sustain the continuation of the family-controlled Singaporean firm rather than protecting the minority interest (p.305). Some IDs and IIs expressed particular concerns about the conflict of interest between minority shareholders and company’s long-term development, and argued that a focus on the interests of small shareholders might promote opportunistic behaviour and be harmful to all listed companies at large. The following comments made by ID8 were typical:

“The ubiquitous practice in the Chinese capital market is that the current shareholders (including small ones) intend to manipulate share price movements. They have a blueprint of share price movement in mind and try

to force the board to take this blueprint as the objective of decision-making. Usually this means maximizing current shareholders' wealth and harming the company's long-term development, because the majority of investors in China only focus on short-term interests".

RL2, an official from the Shanghai Stock Exchange, explained that the reason for emphasizing the protection of minority shareholders' interest was due to the highly concentrated ownership structure in the 1990s when listed companies were usually dominated by one large state shareholder. In the process of ownership structure reform, the regulators have begun to realize that this focus has also created problems and therefore they are attempting to change the focus so that IDs represent all shareholders' interests. Such an attempt is being made through informal discussion instead of formal amendments to regulation (e.g., Zou, 2006).

However, this finding is inconsistent with the concerns over the Type II agency problem expressed in previous studies (e.g., Aharony et al., 2010; Young et al., 2008). The interviewees' above comments, especially those from the regulator, seem to suggest that the Type II agency problem has been overemphasized.

5.1.2 Perceived reasonableness of the control role

In light of the inconsistent understanding of the objectives of ID's control role, the fact the ID mechanism is still new, the poor quality of the law and law enforcement, is it reasonable to expect IDs to play a control role? Consistent with the consensus regarding the desirableness of the control role, there is a certain extent of

agreement on the reasonableness of IDs' control role. As shown in Section 2 of Table 2, 15 out of 26 interviewees considered it reasonable or very reasonable. A statistically significant Chi-square test ($X^2 = 2.90$, Sig.=0.088) indicates a high consensus on the reasonableness of the control role.. Moreover, the Kruskal-Wallis and Wilcoxon tests show statistically insignificant results. Comparing to the consensus on the desirability of this role, this fits into scenario3 (S3 in Fig.1). Thus, no obvious reasonableness gap is observed for the control role.

The interviewees suggested three main reasons for their support of the control role. First, this is the role defined by the regulation, and the main motive for introducing the ID mechanism to China (e.g. ED2, ID5, II4). Second, IDs have been given the right to vote on important decisions and therefore should be able to exercise their control role (e.g., IIs1, 4, ED5, IDs1, 2, 4, 8, 9 & 10). Finally, IDs have the independent status to do so (ED5). This finding is consistent with Reay's (1994) survey in the British context, in which IDs' "watchdog" role is supported by institutional investors.

5.1.3 Perceived effectiveness of the IDs' control role

As shown in Section 3 of Table 2, of the 26 respondents, seven voted "very effective" or "effective", ten remained neutral, while nine voted "ineffective" or "very ineffective". The Chi-square test indicates no significant difference. Compared with the consensus on the reasonableness of the control role, this lack of evidence on effectiveness fits into scenario 7 (S7 in Fig.1) and suggests the existence of a

performance gap for the control role. Furthermore, none of the IIs considered the control role of IDs as being effective or very effective, as compared to four IDs and three EDs who responded favourably. The Kruskal-Wallis test reveals a significant difference in the opinions of the three groups ($X^2 = 9.026$, Sig.=0.011) while the Wilcoxon test illustrates insignificant results. This suggests a more pronounced performance gap for outsiders (IIs) than for insiders (IDs and EDs). This lack of evidence on effectiveness is consistent with the many exposed corporate scandals (Chen et al., 2010) and the findings of Liu and Lu (2004), but contradicts the implications of the findings in China from previous studies of the relationship between ID characteristics and firm performance (e.g., Peng, 2004; Firth et al., 2006; Chen and Lin, 2007).

5.1.4 Factors that affected the effectiveness of the control role and resultant performance gap

The first factor emerging from the interviews is a lack of clear definition of the control role. This can be illustrated by an interesting case involving ID2. The company where he served failed to disclose a large amount of loss from an investment project in its annual report in 2005, and he had to pay a fine of RMB ¥50,000 as a punishment imposed by the CSRC because he was aware of the fraud but did not raise it in IDs' report. He appealed successfully on the basis that he had tried to use his social contacts to help the company reduce the loss as soon as he became aware of the problem, and that his heart was at the right place. RL1, an official from Shenzhen Stock Exchange, commented that: *“We do not expect him to collect the bad debts. His*

priority should be to ensure proper information disclosure". However, the signal released by the successful appeal contradicts his comment, and this conflict reflects the ambiguity on the understanding of the control role.

The second factor is IDs' lack of independence and objectivity. As many IDs are nominated by controlling shareholders, they are criticised as "*interpreters of majority shareholders*" (ED1). ED1 illustrated this point by offering the following example. His company had a proposal for taking over another company. The controlling shareholder, the government, initially agreed, so did IDs. However, the controlling shareholder changed its mind later. IDs simply supported the change without enquiring into or challenging it. Thus, ED1 questioned "*where is "the objectivity of IDs' opinion?"*" The lack of objectivity of IDs is reinforced by the effect of Chinese culture. "*I would feel respected by being invited as an ID, therefore, I would respect you in return: trying to support your proposals.*"(ED8). This point is also made by Liu and Lu (2004).

The third factor is IDs' insufficient time-input. "*The IDs do not have the time to gain an insight into the company's operating processes and activities. I even doubt if they would have the time to read the materials provided to them, let alone further enquiries or investigations*"(ED2). Contrary to previous studies (e.g., Shen, 2005), no ID complained about financial compensation, but felt that their time input was so little that they could not exercise their expected roles effectively.

Finally, the incompetence of IDs hinders the exercise of the control role. Both IDs 2 & 9 estimated that only 50 percent of the current IDs were competent. One typical example was given by ED8 and ID8 in Company 8 where there were three IDs in their company, but only ID8 was regarded as competent. The other two IDs just followed whatever ID8 intended to do.

5.1.5 The reasons for a more significant performance gap in IDs' control role from IIs' perspective

Section 5.1.3 shows that IIs have a more negative perception of the effectiveness of IDs' control role compared with IDs and EDs. The interview data revealed two contributors. First, the communication and probing before the board meeting were invisible. All IDs interviewed acknowledged that they exchanged ideas informally with EDs before board meetings and formal pre-board meetings. ED9 described how it worked: *“You rarely see any disagreement in annual reports. All have been sorted out before the BoD meetings. If no agreement upon a proposal could be reached, the proposal would not appear at the BoD meeting. It would be given up or discussed in the future.”* Under such circumstances, the IDs' efforts would not be observed by outsiders (e.g., IIs or other individual investors).⁵ Indeed, IIs complained that they had not seen many disclosed cases where IDs voted against proposals at board meetings.

⁵ Some outsiders may become less critical of IDs for not expending sufficient time on their ID jobs should they know the invisible nature of part of the work done by IDs. However, our interviewees, including the IDs, consider that IDs' lack of time commitment is a general problem.

Second, there existed a strong distrust in IDs' capability to play the control role. This is reflected in I15's remarks: "*It is common in China that corporate governance is not effective...Therefore, We would not consider IDs when we make investment decisions. We would only be alerted when the ID(s) of our invested company suddenly resign, because that usually signals a conflict of interest and the share price of that company could be expected to shift dramatically*" (I17). None of the IIs interviewed put IDs as an important factor in their investment decision making.

Overall, the analysis suggests that the control role is perceived to be necessary and reasonable but not performed effectively. The evidence suggests a performance gap, but no reasonableness gap, and the performance gap perceived by IIs is larger than that perceived by EDs and IDs. Moreover, contrary to the concerns on Type II agency problem raised by prior studies, the data revealed that such concerns may not be warranted.

5.2 The strategic role

5.2.1 Should IDs play a strategic role?

As shown in Section 1 of Table 3, a large majority of interviewees (21 out of 24⁶) agreed that IDs should play a strategic role. This tendency is supported by the Chi-square test ($X^2 = 13.500$, Sig. = 0.000). Moreover, this consensus also existed in

⁶ As two IIs did not comment on the strategic role, the total number of interviewees in the analysis is reduced from 26 to 24.

each of the three interview groups as no significant difference was shown by the Kruskal-Wallis and Wilcoxon tests.

There are no particular stated requirements in the Code and Guidelines (CSRC 2001; 2002) regarding the strategic role. The attitudes of interviewed regulators were neutral, taking the view that this role is a good supplement, but not a compulsory one. *“We did not say IDs should not play a strategic role, but the control role should be their main focus”* (RL1). *“We expect that they involve more in strategic management process in the future when IDs become more competent.”* (RL2).

During the course of our interviews, the most commonly referred reason for IDs to play a strategic role was that *“an ID firstly is a director and shares the same responsibility with executive directors”* (e.g., IDs 1, 2 & 9, EDs 2, 3 & 4). IDs 1 & 10 stated that participating in strategic decision making was important for protecting minority shareholders’ interests. However, other interviewees stated that the main responsibility of IDs is not to make strategic decisions but to participate in decision making processes in the capacity of an adviser or a specialist (e.g., EDs 2, 3 & 9; IDs 1, 6 & 8; IIs 2, 3, 4, 5 & 8). Moreover, EDs expect IDs to provide advice on strategic issues not just for firms’ performance improvement but also for their career risk management. ED3 made the following comments:

“The presence of IDs in the decision-making process would actually help protect the managers. In case something goes wrong, the manager can

indicate that he/she has followed all the procedures and consulted the IDs as expected and hence, she/he will not be penalised for the loss”.

This viewpoint received broad support from other EDs we interviewed. It provides evidence in the Chinese context for Brennan’s (2006) view that directors may not necessarily take shareholder value as their first priority.

5.2.2 Reasonableness of the strategic role

There was also an overall consensus on the reasonableness of the strategic role (18 out of 24 interviewees considered it as being reasonable or very reasonable). This is supported by the Chi-square test ($X^2 = 19.75$, Sig.=0.000). Moreover, the Kruskal-Wallis and Wilcoxon tests show no significant differences in the opinions of the three groups and between the paired IDs and EDs. Integrating the results from Section 5.2.1, the overall evidence fits into scenario 3 (S3 in Fig.1): no obvious reasonableness gap is observed regarding the strategic role.

As most listed companies choose their IDs from accountants or industry-specific specialists, it is reasonable to expect IDs to provide professional advice to help companies’ development (e.g., EDs 1, 2, 3, 5 & 6, IDs 2 & 8, IIs 2 & 4). Some IDs thought that getting involved in the strategic decision making process was an important way to exercise monitoring and control (IDs 2, 3 & 4). In addition, a strategic advisory role would appear to be less likely to cause tension between EDs and IDs compared to exercising the control role in the Chinese cultural context (RL1).

5.2.3 Perceived effectiveness of the strategic role

Section 3 of Table 3 reveals diverging opinions on the effectiveness of the strategic role: eight interviewees voted “very effective” or “effective”, but ten interviewees voted “very ineffective” or “ineffective”. The remaining six interviewees remained neutral. The Chi-square test indicates no significant difference. There is no evidence to suggest a difference among the three groups and between IDs and EDs as neither the Kruskal-Wallis test nor the Wilcoxon test revealed significant results. This result does not provide evidence that IDs played an effective strategic role, illustrating the existence of a performance gap (S7 in Fig.1).

Apart from the shortage of time-input by IDs, another contributing factor lies in the fact that many IDs do not possess specific industry and business knowledge, which is essential for strategic participation. RL2 remarked: *“The majority of the IDs in listed companies are academics. There is a shortage of candidates with experience in industries”*, a point echoed by many other interviewees (e.g., EDs 2, 3, 5, 9; IDs 4, 6, 8 & 9; IIs 1, 4 & 5; RL 1).

In summary, while our interviewees considered the strategic role desirable and reasonable, they focused the strategic role on advice and participation rather than decision-making. This is consistent with the findings by Huse (2005) and Rindova (1999). However, there is little evidence to suggest that Chinese IDs performed the strategic role effectively.

5.3 The resource provision role

5.3.1 Desirability, reasonableness and effectiveness of the resource provision role

Table 4 shows that the perceptions on the resource provision role are much more diverse compared to those on the control and strategic roles. Section 1 of Table 4 reveals that 12 interviewees responded “no”, ten “yes” and four “no comments” when asked whether IDs should play a resource provision role. As shown in Section 2 of Table 4, eight out of 18 interviewees expressed a negative opinion whereas eight others were positive about the reasonableness of this role. Section 3 of Table 4 shows that seven interviewees considered the resource provision role ineffective or very ineffective, six interviewees were positive, and five remained neutral. The Chi-square, Kruskal-Wallis and Wilcoxon tests provide no significant results on the desirability, reasonableness and effectiveness of the resource provision role. This indicates that there is no consensus on the three dimensions of the role and there is no significant opinion difference among the three groups, and the two pair groups, of interviewees. Hence, the overall evidence is inconclusive about the existence of either a reasonableness gap or a performance gap.

The observation of favourable and unfavourable responses further shed light on this diversity. For example, while some interviewees thought IDs’ reputation and resources could ensure investors’ confidence and support companies’ development (e.g., ID10 ED3, II2), some thought that this role might have ruined IDs’ reputation (e.g., ID6, ID2). To support the latter, ID6 stated: *“When an ID possesses special access to certain resources, especially government resources, this might motivate the*

company to rely on this advantage and not to focus on the development of its competitive advantage.”

5.3.2 Reasons for the lack of consensus over, and willingness to acknowledge the performance of the resource provision role

Although the above evidence was inconclusive, all interviewees valued the resource contribution of IDs in terms of their expertise. As accountants, lawyers, industry specialists, or managers, IDs were considered to have provided valuable advice in such areas as internal control, taxation, macro-economic issues, government policy and strategic planning.

Although “Guanxi” has been regarded as an important characteristic of Chinese culture, the interviewees were reluctant to acknowledge the contributions from IDs’ social contacts, especially those related to government resources. The EDs tried to make an impression that the resource role was an added bonus. For example, “*having resources is better than not having any*” (ED8), or “*it is not a critical factor in the nomination of an ID, but if other things are equal, having a resource role is not a bad thing*” (ED2).

The EDs and IIs tended to view the use of social contacts for improving firm performance negatively, perhaps because usually this resource only works in the short-term and may signal the lack of self-development ability in the long-term. The IDs’ reluctance might also be related to “face value - Mianzi” (Chen, 2003) in the sense that the benefits from social contacts might be seen as advantages gained from

unfair competition. According to some interviewees, people tend to think that some IDs are appointed purely because of their social contacts, implying that IDs are not really competent or qualified in their field of expertise (e.g., ID8 and II7). Consequently, interviewees were more willing to discuss their contributions from their expertise.

6. Conclusion

This paper has explored whether there is a reasonableness gap and a performance gap in IDs' control, strategic and resource provision roles in a Chinese context. The overall evidence suggests a performance gap, but no reasonableness gap in the control and strategic roles. The performance gap can be attributed to several factors including the ill-defined roles, IDs' limited time commitment, and their lack of industry and business knowledge, competence, and objectivity. Interestingly, these impediments are in line with Brennan's (2006) findings based on a literature review.⁷

While our investigation has focused on internal factors, we recognise that the limited role performed by IDs may also be due to external factors. In general, corporate governance is relatively new in China, the legal system is far from being perfect, shareholder protection is under-developed, and independent and government monitoring mechanisms such as auditing and securities watchdogs are weak. If mega

⁷ However, Brennan (2006) considers lack of clarity and agreement on the role of boards as a contributor to reasonableness gaps while our interviewees regarded it as a contributor to performance gap.

corporate frauds and corporate governance failures could occur in developed markets, it is no surprise that IDs can be less effective than expected in China. In a weak corporate governance environment, even truly independent directors would find it difficult to exercise their roles effectively. The introduction of IDs in China is new. Experiences in developed countries such as the UK show that it takes time to develop their roles. Moreover, the effectiveness of IDs may have been affected by path dependence (Bebchuk and Roe, 1999). This is evident from the fact that Chinese IDs are usually appointed by controlling shareholders who are likely either government agencies or other SOEs. Not only does this threaten IDs' independence, but it also introduces non-economic objectives and reinforces Type II agency problems.

This does not mean that nothing can be done to improve IDs' performance. To the contrary, the above identified specific reasons for IDs' underperformance indicate issues that should be addressed and suggest measures to be taken to make IDs' roles more effective. Our findings indicate a need to define IDs' roles clearly. Given that the control and strategic roles are considered desirable and reasonable, it is useful to provide specific guidance as to how such roles can be effectively exercised.

There is also a need to enhance IDs' competence and commitment. Indeed, Chinese authorities have already taken many measures. For example, the CSRC requires IDs to complete a training course, pass a formal test prior to appointment, be

retrained at least once within one appointment period, and spend no fewer than 10 days to undertake field studies in the companies they serve.⁸

We also found no consensus on the desirability, reasonableness and effectiveness of IDs' resource provision role despite wide acknowledgement of the provision of professional expertise by the IDs and some anecdotal evidence of the provision of social capital to the firms that IDs serve. We discovered that one of the important reasons for the under-appreciation of IDs' performance of this role is the pejorative connotation of 'Guanxi'. This may also be because the exercise of this role could counteract the effort of the CSRC to curb the rampant related party transactions and its effort to keep listed firms separate from their parent companies, large shareholders, and government. This finding suggests a cultural dimension to IDs' corporate governance roles, which echoes the call for further research into informal, soft elements of corporate governance in emerging economies (Young et al., 2008).

It is particularly interesting that many of our interviewees disagreed with the traditional view that the objective of IDs' control role is to protect minority investors. They argued that to do so may harm the long-term interests of all shareholders given the highly speculative nature of minority shareholders in China. This view also implies that government as majority shareholders is less speculative and proxies for the firm's long term wealth creation, not to say the public interest and hence there is

⁸ In contrast, all directors in the UK should receive induction on joining the board and regularly update their skills and knowledge (FRC, 2010).

room for it to play a positive role in corporate governance.⁹ However, this view contradicts the abounding evidence in the literature which shows the existence of many principal-principal conflicts of interest (Aharony et al., 2010; Young et al., 2008). Some interviewees also criticised IDs as representatives of controlling shareholders, implying the existence of such conflicts. Further research is needed to ascertain the nature of the debate.

Interviewing several different groups of interviewees has enabled us to identify some significant and interesting perception differences among the groups and trace some causes of the differences. For example, we find that IIs perceived a larger performance gap with respect to the control role than the other groups of interviewees mainly because some activities of IDs are not easily observable by outsiders and because IIs have little regard for corporate governance in general and the role of IDs in it in particular.

While our study helps remedy a significant and unfortunate void in the literature, it is explorative in nature, based on a dataset collected through a small non-random sample of IDs, EDs, IIs and regulators. A replication using a random, larger and more comprehensive sample would help confirm our findings and overcome the limitations of our small and convenience sample. Furthermore, although our findings indicate certain measures that could be taken to enhance the effectiveness

⁹ We thank an anonymous reviewer for suggesting this point.

of IDs' roles, it would be useful to undertake a specific study to systematically chart the problems of IDs' underperformance and their causes and to identify a comprehensive set of remedies. Finally, it may be interesting to extend our study in other contexts, especially in other emerging markets.

Appendix 1: Interview Questions

Company:

Position:

For how long have you worked in the company?

For how long have you worked on the current position?

Qualifications:

Gender:

Section One(Two/Three): Control Role (Strategic Role /Resource Provision Role)

Q1. Do you think that IDs should play a control role (strategic role/resource provision role)? Why?

Q2. Under the current circumstances, to what extent do you think it is reasonable to expect IDs to fulfil the control role (strategic role/resource provision role)? Why?

Q3. To what extent do you think IDs have played the control role (strategic role/resource provision role) effectively?

Q4. What factors facilitate or impede IDs in the execution of the control role (strategic role/resource provision role)? Please provide examples.

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