

## OUTSIDE DIRECTORS AND FIRM PERFORMANCE DURING INSTITUTIONAL TRANSITIONS

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*Do outside directors on corporate boards make a difference in firm performance during institutional transitions? What leads to the practice of appointing outside directors in the absence of legal mandate? This article addresses these two important questions by drawing not only on agency theory, but also resource dependence and institutional theories. Taking advantage of China's institutional transitions, our findings, based on an archival database covering 405 publicly listed firms and 1211 company-years, suggest that outsider directors do make a difference in firm performance, if such performance is measured by sales growth, and that they have little impact on financial performance such as return on equity (ROE). The results also document a bandwagon effect behind the diffusion of the practice of appointing outsiders to corporate boards. The article not only highlights the need to incorporate multiple theories beyond agency theory in corporate governance research, but also generates policy implications in light of the recent trend toward having more outside directors on corporate boards in emerging economies.*

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Do outside directors on corporate boards make a difference in firm performance? Agency theory suggests that a board comprised of a greater proportion of outside directors, due to their presumed independence, may theoretically lead to better firm performance (Jensen and Meckling, 1976; Shleifer and Vishny, 1997). However, empirical researchers report that overall, there is little significant relationship between outside directors and firm performance (Dalton *et al.*, 1998; Finkelstein and Hambrick, 1996). Consequently, Dalton *et al.* (1998: 285) argue that 'consideration of multiple theories [beyond agency theory] ... may lead to a more complete understanding.' We agree, and add that

additional perspectives such as resource dependence and institutional theories may be particularly insightful in advancing this research. Specifically, resource dependence theory suggests that firms may appoint outsiders to the board in order to tap into resources these outsiders may bring (Pfeffer, 1972). On the other hand, institutional theory argues that appointing outsiders to the board may merely represent firms' attempts to comply with institutional pressures, and, therefore, may not necessarily result in better firm performance (DiMaggio and Powell, 1983).

Although the debate on the link between board composition and firm performance is hardly resolved in developed economies, appointing outsiders to corporate boards has become an increasingly widespread practice in emerging economies going through institutional transitions such as China, which provides an interesting 'research laboratory' (Shenkar and von Glinow, 1994: 56). Institutional

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transitions can be defined as 'fundamental and comprehensive changes introduced to the rules of the game that affect organizations as players' (Peng, 2003: 275). Corporate governance in emerging economies such as China has experienced some of these transitions (Buck *et al.*, 1999; Puffer and McCarthy, 2003; Young *et al.*, 2002). Specifically, between 1990 when the first companies were listed in China's new stock exchanges and 2001 when the government required that independent outside directors be appointed to the board (CSRC, 2001), there was a period during which some (but not all) firms *voluntarily* appointed outsiders to the board. Largely influenced by agency theory, public opinion in China has been in favor of appointing more outside directors, thereby creating increasing institutional pressures for companies to adopt this practice. However, what remains unknown is: (1) Do outside directors *really* have a positive influence on firm performance during institutional transitions? (2) What leads to the practice of appointing outside directors to corporate boards in the absence of legal mandate?

Drawing on agency, resource dependence, and institutional theories, this article extends the debate on the outside directors/firm performance link to emerging economies, by addressing these two theoretically important but empirically under-studied questions in China. Three compelling theoretical, empirical, and policy reasons motivate this research. First, a focus on China is theoretically important, because it allows us to investigate the link between outside directors and firm performance in an under-explored context (Child, 1994; Peng, 2000, 2003). Since so much work is U.S.-based, our study can be positioned as a 'replication with extension' (Hubbard, Vetter, and Little, 1998: 246; Tsang and Kwan, 1999). Second, empirically, given that China is already the largest emerging economy (in terms of GDP) and the largest recipient of foreign direct investment (2002) and is likely to become the second largest economy in the world in the foreseeable future, we need to know more about 'what is going on there' if the field aspires to become *globally* relevant (Hoskisson *et al.*, 2000; Peng, 2003). Finally, from a policy standpoint, despite consistent non-findings for the outside directors/firm performance link in the West (Dalton *et al.*, 1998), this link is still important because the evident belief in its existence embodied in the new Chinese regulations (CSRC, 2001), in the absence of concrete empirical

evidence (Clarke, 2002: 24), necessitates rigorous empirical scrutiny.

## DEFINING OUTSIDE DIRECTORS

Since inside directors tend to be defined as directors currently serving as firm officers, outside directors are often defined as 'all non-management members of the board' (Johnson, Daily, and Ellstrand, 1996: 417). This is the definition we use in this article. However, outside directors are not necessarily the same as independent directors. In particular, some outside directors may be affiliated directors in that they may have family and/or professional relationships with the firm or firm management. Although they are not employees, they may have been co-opted by management through family and/or business ties (Hillman, Cannella, and Paetzold, 2000: 237). Therefore, we also make a distinction between *affiliated* outside directors and *non-affiliated* outside directors, defined as *non-management directors who have family and/or professional relationships with the firm or firm management* and *non-management directors with no such relationships*, respectively.

A unique problem we encounter is how to classify directors who represent state interests. Although most listed companies in China are joint-stock companies transformed from traditional state-owned enterprises (SOEs), for political reasons the Chinese officially do not call the public listing of these firms 'privatization.' Instead, the term 'corporatization' is often used, suggesting that traditional SOEs are transformed to modern joint-stock corporations (i.e., 'corporatized') with explicit equity contributions from a number of shareholders, of which the state is one such shareholder (usually the largest) (Peng, 2000). As a result, instead of having government bureaucrats directly supervising the SOEs as before, the state now formally exercises its rights as a major shareholder by appointing directors to the board (Tenev and Zhang, 2002). However, Dharwadkar, George, and Brandes (2000: 656) argue that although technically the state is now a major 'outside' shareholder, its long history of involvement with these firms leads it to display the dynamics of an 'insider.' We agree. Consequently, in this article, 'outsider directors' specifically refer to *non-management, non-government directors*.

## AGENCY, RESOURCE DEPENDENCE, AND INSTITUTIONAL PERSPECTIVES

Since boards of directors play multiple roles for control, monitoring, and resource dependence purposes (Johnson *et al.*, 1996), three theories reviewed here form the building blocks for this study.

### Agency theory

Agency theory suggests that the separation of corporate ownership and control potentially leads to self-interested actions by managers (Jensen and Meckling, 1976). To combat agency problems, outside directors, due to their presumed independence relative to insiders, may be able to do a better job in monitoring and controlling management, thus helping improve firm performance (Walsh and Seward, 1990). In the conceptual, practitioner, and policy literature, there is a near consensus in favor of a higher proportion of outside directors. However, the empirical literature is not nearly as uniform. A meta-analysis of 54 studies leads to a 'very strong conclusion that the true population relationship ... is near zero' (Dalton *et al.*, 1998: 282). The contrast between agency theory's strong theoretical logic and widespread policy influence *vis-à-vis* its inconclusive empirical record has prompted scholars to search for alternative theories, which we turn to next.

### Resource dependence theory

Resource dependence theory views board directors as boundary spanners who extract resources from the environment (Pfeffer, 1972). It predicts that the more resource-rich outside directors are on the board to help bring in needed resources, the better the firm performance. This claim has received some empirical support (Dalton *et al.*, 1999). For example, Boyd (1990) and Hillman *et al.* (2000) find that during times of environmental uncertainty firms are likely to appoint resource-rich outsiders to the board. Carpenter and Westphal (2001) report that outside directors with network ties to strategically related firms contribute to the strategic decision-making process. In general, bringing in outside directors through interlocking directorates may facilitate firms' borrowing (Mizruchi and Stearns, 1994), information acquisition (Haunschild and Beckman, 1998), and

alliance formation (Gulati and Westphal, 1999). On the other hand, although Westphal (1999) reports a positive relationship between advice and counsel provided by outside directors via interlocks and financial performance, overall, direct evidence capturing the link between interlocks and performance, based mostly on U.S. studies, is 'mixed at best' (Mizruchi, 1996: 284). Consequently, Mizruchi (1996) posits that while outside directors via interlocks may have a positive impact on firm performance in other places, this needs to be demonstrated empirically.

Several studies suggest that Chinese organizations may represent an alternative context to advance this research. First, case studies by Au, Peng, and Wang (2000) and Young *et al.* (2001) report that, relative to Western boards, the resource dependence function is more pronounced for Chinese boards. Both the Chinese cultural propensity to rely on relationships (*guanxi*) to get things done and the institutional imperative to activate network ties during institutional transitions (Peng, 2003) are argued to be behind the heightened role of resource dependence. Second, surveys by Keister (2000), Park and Luo (2001), and Peng and Luo (2000) document that managerial networks such as board interlocks have a positive influence on firm performance. However, all these studies employ relatively small-sample interview and survey data. Whether such influence can be found with more accessible, larger-sample archival data remains to be seen.

### Institutional theory

Institutional theory suggests that firms may appoint outside directors for a variety of different reasons. Scott's (1995) three 'pillars' of institutionalization—regulative, normative, and cognitive—help us understand some of these underlying dynamics (Peng, 2003). At first glance, the regulative 'pillar' such as corporate law—or 'coercive isomorphism' according to Meyer and Rowan (1977)—may be applicable. However, in China, until the August 2001 enactment of legal requirements mandating that listed companies appoint outsiders to their boards (CSRC, 2001),<sup>1</sup> there had been no regulatory mandate to do so. Then, how to explain the

<sup>1</sup> In comparison, U.S. Congress passed the Sarbanes-Oxley Act, which required outside directors on the board, in 2002, approximately a year *after* the enactment of similar Chinese requirements.

increase of outsider board directors during a period characterized by the *lack* of regulatory mandate for outside directors?

Second, it appears that the normative 'pillar' of the institutional environment may play an important role behind the rising number of outsiders on the board. Despite the lack of legal mandate, scholarly opinion and press coverage in China (Xu and Wang, 1999) have heightened the normative demand for more outside directors. Institutional theory suggests that organizations seek to behave in ways that will not cause them to be noticed as different and consequently singled out for criticism (Meyer and Rowan, 1977). Firms experiencing performance problems are especially likely to be under such normative pressures (Boeker and Goodstein, 1991).

Third, similar to the lack of regulative pressures, cognitive pressures for having more outside directors may also be absent. 'Deep down, many CEOs really wish they didn't have boards. That's why, at the end of the day, most independent directors get neutralized in one fashion or another' (Smale, 1995: 8). While this observation is made in the United States, we suspect that it applies to China as well. For example, 7 percent of surveyed CEOs in China, when asked 'What is the solution to the most serious corporate governance problem?' actually answered 'To *reduce* the intervention from the board' (Gu, Li, and Gao, 1999: 145, added emphasis). At the same time, CEOs understand that display of conformity can yield significant benefits, such as increased legitimacy, resources, and survival capabilities (Scott, 1995). Therefore, it is not surprising that CEOs often appoint outsiders who are less likely and/or willing to challenge CEOs (Westphal and Zajac, 1995).<sup>2</sup>

<sup>2</sup> Although agency theory *assumes* that outside directors may be more independent, the reality is that (1) not every outside director is likely to be truly independent, given the presence of affiliated outside directors discussed earlier, and that (2) even in the case of non-affiliated (and hopefully truly independent) outside directors, CEOs may still employ a number of tactics to neutralize the power of these directors. For example, this can be done by appointing outside directors who are demographically similar, and therefore more sympathetic, to CEOs (Westphal and Zajac, 1995). CEOs may also appoint directors with experience on other passive boards and exclude individuals with experience on more active boards (Zajac and Westphal, 1996). Alternatively, CEOs may appoint individuals who are from strategically irrelevant backgrounds which may not provide an appropriate knowledge base to effectively participate in strategic decision making and challenge CEOs' power (Carpenter and Westphal, 2001).

In summary, despite the absence of strong regulative and cognitive imperatives, normative expectations may have compelled many firms to appoint more outside directors. Firms may strategically comply with the institutional demands for more outside directors, while subtly limiting the independence of the board on the other hand (Oliver, 1991; Westphal, 1999; Zajac and Westphal, 1996). Thus, institutional theory argues that greater outside board representation is not necessarily linked with higher firm performance.

## INSTITUTIONAL TRANSITIONS IN CORPORATE GOVERNANCE

A major component of China's institutional transitions since the 1980s focuses on the corporate governance of traditional SOEs (Fan, Lau, and Wu, 2002; Peng, 2000; Tenev and Zhang, 2002). Directly supervised by the government, traditional SOEs do not have boards of directors. However, since officials and bureaucrats themselves are agents of the government who often have incentive problems, they have not vigilantly pushed SOEs to focus on performance, thus, in part, contributing to widespread SOE performance problems (Child, 1994; Shenkar and von Glinow, 1994). Consequently, reforms to transform SOEs to joint-stock (but still state-owned) companies were initiated in the 1980s with the explicit aim to enhance performance. A key difference between a traditional SOE and a joint-stock company is that the latter has a number of shareholders (the largest of which is typically the state), and is required to have a board (Table 1). Since the opening of the two stock exchanges in Shanghai and Shenzhen in 1990 and 1991, respectively, only joint-stock companies with boards are allowed to list shares.

Despite the lack of legal requirements on board composition (prior to August 2001), official speech (Cha, 2001) and scholarly opinion (Gu *et al.*, 1999; Xu and Wang, 1999), which is influenced by agency theory, had been largely in favor of appointing more outside directors, who are supposed to protect the interests of shareholders (Clarke, 2002). However, these reforms take place in an emerging economy heavily influenced by its socialist legacy (Peng, 2000). Many top managers at the newly listed joint-stock companies are executives who have built their entire career at traditional SOEs, and may not have internalized

Table 1. Institutional transitions of corporate governance in China

	Key events	Implications for boards of directors/outside directors
1980s	Reforms to transform traditional state-owned enterprises (SOEs) to joint-stock companies started in the late 1980s	Directly supervised by government agencies, traditional SOEs do not have boards of directors. Once transformed to become joint-stock companies, they are required to have boards
1990–91	Shanghai and Shenzhen Stock Exchanges opened	Listed firms must be joint-stock companies with boards. There is no legal specification on board composition
2001	<i>Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies</i> enacted by China Securities Regulatory Commission (CSRC)	All listed companies are required to introduce independent (outside) directors to the board
2002	—	By 30 June 2002, at least two members of the board should be independent directors (per <i>Guidelines</i> , see CSRC, 2001)
2003	—	By 30 June 2003, at least one third of the board should be independent directors (per <i>Guidelines</i> , see CSRC, 2001)

Sources: CASS (1998); CSRC (2001); Tenev and Zhang (2002).

the need for effective board control. As a result, they may feel the urge to have certain ‘cosmetic’ changes such as having some outside directors, but may not necessarily change their mindsets. Thus, according to Laura Cha, a former Hong Kong Securities and Futures Commission official who became the vice chair of the China Securities Regulatory Commission (CSRC—the Chinese equivalent of the SEC in the United States), the transformation from traditional SOEs to joint-stock companies is often ‘more in form than in substance’ (Cha, 2001: 2).

In summary, what is changing is, first, the introduction of boards of directors to joint-stock companies whereby boards did not exist before, and, then, the emerging interest in appointing outside directors to these boards. Overall, appointing outside directors seems to be less driven by the regulatory and cognitive ‘pillars’ of institutionalization and largely propelled by the normative ‘pillar’ (Ahmadjian and Robinson, 2001: 628).

## HYPOTHESES

### Outside directors and firm performance

During the 1990s, a typical listed joint-stock company in China had a mixed ownership structure with three predominant shareholder groups—the

state, institutional (legal person) investors, and individual investors—each with approximately one-third of the stock (Xu and Wang, 1999: 75).<sup>3</sup> At the board level, in addition to inside directors, there are correspondingly these three kinds of non-management directors. Given our earlier discussion considering state directors as quasi-inside directors, our hypotheses only focus on the role of outside directors, namely, those representing institutional and individual investors.

Agency theory suggests that firm performance is positively related to the presence of large shareholders, i.e., blockholders (Shleifer and Vishny, 1997). Empirical research in developed economies such as the United States (Hill and Snell, 1988) and emerging economies such as China (Qi, Wu, and Zhang, 2000; Xu and Wang, 1999), Czech Republic (Claessens and Djankov, 1999), India (Ramaswamy, Li, and Veliyath, 2002), and Russia (Buck *et al.*, 1999) largely confirms this proposition. Extending this logic, it seems plausible that at the board level outside directors representing large shareholders, especially those *non-affiliated* outside directors, may more likely be concerned with performance in order to maximize

<sup>3</sup> As of 1997, foreign investors controlled a relatively insignificant portion of approximately 2.6 percent of the total equity of joint-stock companies in China (CASS, 1998: 36), and they have not been appointed to boards of directors.

their investment. Similarly, resource dependence theory argues that outside directors are likely to bring useful resources from other organizations (Pfeffer, 1972). Among outside directors, *affiliated* outside directors may be especially helpful because they facilitate the social and/or professional ties between the firm and its stakeholders. Recent work in China (Keister, 2000; Park and Luo, 2001; Peng and Luo, 2000) as well as Hong Kong (Au *et al.*, 2000), Taiwan (Young *et al.*, 2001), and Thailand (Peng, Au, and Wang, 2001) further points to this direction. Therefore, as far as outside directors (without delineating the difference between affiliated and non-affiliated directors) are concerned, resource dependence theory leads to essentially the same prediction as agency theory:

*Hypothesis 1a: Greater representation on the board by outside directors has a positive effect on firm performance.*

Institutional theory, on the other hand, argues that organizational changes such as appointing more outside directors may 'occur as the result of processes that make organizations more similar without necessarily making them more efficient' (DiMaggio and Powell, 1983: 147). Given that outside directors may be affiliated or non-affiliated, it seems imperative to differentiate these two types. First, the majority of institutional (or 'legal person') investors in China are *not* financial organizations such as mutual funds and pension pools; instead, most of them are other companies such as buyers, suppliers, banks, and alliance partners that have transaction and/or cooperative relationships with the focal firm (Peng, 2000). Building from informal networks dating back to the 1980s, most of these relationships were formalized in the 1990s through mutual shareholdings and board interlocks (Au *et al.*, 2000; Keister, 2000). Thus, it seems reasonable to suggest that most directors representing such institutional investors are *affiliated* outside directors. Therefore, it may not be realistic to expect directors representing these friendly institutional investors to challenge management.

Second, excluding those with family and/or professional relationships with the firm (who represent a very small minority), most individual investors may be *non-affiliated* outside directors. Although these individual investors represent the purest type of outside directors theoretically most likely to be independent from management according to

agency theory, they represent a widely dispersed group of investors. As small shareholders each normally with less than 0.5 percent of the equity, the majority of them have little knowledge of and interest in corporate governance (Xu and Wang, 1999: 84). Therefore, they may not be able to have a positive impact on firm performance either. In other words, institutional theory would suggest that regardless of whether these outside directors are affiliated or non-affiliated, they may not matter. This line of argument, for example, has been supported by a recent study in Russia by Peng, Buck, and Filatotchev (2003). Therefore:

*Hypothesis 1b: Greater representation on the board by outside directors has a negligible effect on firm performance.*

### The diffusion of outside directors on the board

Even if Hypothesis 1b is supported, such findings would still beg for an answer as to what leads to the appointment of outsider directors in the absence of legal mandate. Institutional theorists have long dealt with the rationale behind the emergence of practices without obvious economic value (DiMaggio and Powell, 1983; Meyer and Rowan, 1977). Since a core assumption of institutional theory is that organizations act to enhance or protect their legitimacy, copying other reputable organizations—even without knowing the direct performance benefits of doing so—may simply be a low-cost heuristic to gain legitimacy. New organizational practices (e.g., total quality management, appointing outside directors) are generally regarded as state-of-the-art techniques (Westphal, Gulati, and Shortell, 1997). Therefore, jumping on such a 'bandwagon' may be perceived 'as a form of innovation when it is contrasted with the more passive act of ignoring industry trends or the more active stance of rejecting them altogether' (Staw and Epstein, 2000: 528). While scholars may interpret these actions as chasing fads (Abrahamson, 1996), practitioners are likely to view them as a *signaling* device to keep up with competition—at least symbolically (Spence, 1973). When there is so much ambiguity in attributing the causes of organizational outcome such as performance, outside observers often rely on positively valued behavior as a signal in making their judgments of a firm's management, therefore gradually

fueling firms' interest in engaging in certain desirable behavior (Aldrich and Fiol, 1994; Fiol and O'Connor, 2003).

While many firms face the rising normative expectations for appointing outside directors, they are not likely to join such a bandwagon with the same pace. There may be at least three organizational attributes that differentiate the early adopters from late adopters. First, poor prior performance of the firm may prompt more appointment of outsiders on the board who may help the turnaround process (Boeker and Goodstein, 1991; Hermalin and Weisbach, 1988). In this manner, poor performance acts as a catalyst to trigger organizational changes (Ahmadjian and Robinson, 2001). On the other hand, high-performance firms, which may still have a board dominated by insiders, are not under as much pressure to introduce new outsiders to the board as their low-performance counterparts. Therefore:

*Hypothesis 2: There is a positive relationship between poor prior performance of the firm in a previous year and the appointment of outside directors to the board in a given year.*

Second, large firms are likely to be under greater pressure to maintain legitimacy by responding to institutional demands (Meyer and Rowan, 1977). Because of their visibility, these firms tend to be scrutinized more intensely by officials, scholars, and journalists. Given the increasingly vocal public opinion in China in favor of having more outside directors, institutional theory suggests that large firms may have incentives to have some outsiders on the board, even if only for symbolic purposes. In addition, resource dependency theory (Pfeffer, 1972) posits that because larger firms have more uncertainty and interdependence with environmental contingencies, their boards would be larger with more outsiders. Thus, both theories converge to suggest:

*Hypothesis 3: There is a positive relationship between a large firm size in a previous year and the appointment of outside directors on the board in a given year.*

Third, formal structural arrangements such as the board tend to reflect the historical era in which they originate, since organizations generally adopt and retain the form that is predominant at that

time (Tolbert and Zucker, 1983). Older, more established firms usually have well-entrenched structures supported by vested interests, and initially may not be interested in introducing new governance practices. On the other hand, younger firms may be more likely to appoint outsider directors, because they may have stronger incentives to establish their legitimacy by conforming to the demands of the new environment in order to combat their liability of age (Aldrich and Fiol, 1994; Fiol and O'Connor, 2003). Therefore:

*Hypothesis 4: There is a positive relationship between a young firm age in a previous year and the appointment of outside directors to the board in a given year.*

Finally, it is possible that during the transitions the more other firms appoint outsiders to the board, the more likely that any given firm is to follow (Ahmadjian and Robinson, 2001). Although the diffusion is initially driven by the efficiency motives of early adopters (such as those with performance problems), late adopters are likely to follow for symbolic legitimacy reasons (Westphal and Zajac, 1994). As the practice diffuses to more firms, the three predictive factors identified above may become increasingly less relevant to the adoption process (Tolbert and Zucker, 1983). Thus, isomorphism may be manifested empirically as increased conformity to the emerging norm of appointing outside directors (Westphal *et al.*, 1997; Westphal and Zajac, 1994).

*Hypothesis 5: The strength of the relationship between (a) poor prior performance, (b) large firm size, and (c) young firm age on one hand and the appointment of outside directors to the board on the other hand will decrease over time.*

## METHODOLOGY

### Sample

By the end of 1996, while there were approximately 36,000 joint-stock companies in China (CASS, 1998: 32), we focus on all the 530 firms listed on the Shanghai and Shenzhen Stock Exchanges, whose combined capitalization was approximately 25 percent of China's GDP. Although a small number of non-SOEs are listed,

Table 2. The evolution of publicly listed companies in China during the sampling period (1992–96)

	1992 <sup>a</sup>	1993	1994	1995	1996
Total number of listed firms <sup>b</sup>	52	181	291	323	530
Number of listed joint-stock SOEs <sup>c</sup>	51	178	285	316	515
Number of listed joint-stock non-SOEs	1	3	6	7	15
Number of firms listed in Shanghai	29	105	171	188	293
Number of firm listed in Shenzhen	23	76	120	135	237
Market capitalization (billion yuan) <sup>d</sup>	119.0	352.3	364.3	346.8	984.3
Market capitalization in Shanghai (billion yuan)	71.5	218.8	259.7	252.4	547.8
Market capitalization in Shenzhen (billion yuan)	47.5	133.5	104.6	94.4	436.5
Sampled company-years (total $N = 1211$ )	49	173	274	310	405

<sup>a</sup> The year 1992 is the first full year when both national stock exchanges in China were in operation.

<sup>b</sup> Including both firms issuing A shares (denominated in yuan) and B shares (denominated in U.S. dollars).

<sup>c</sup> All sampled firms are in this category. No listed, joint-stock non-SOE is sampled.

<sup>d</sup> The exchange rate during this period was approximately U.S. \$1 = 8.3 yuan.

Sources: CASS (1998: 44); [www.csrr.gov.cn](http://www.csrr.gov.cn)

the majority of listings are SOEs transformed to become joint-stock companies (Table 2). So are *all* sampled firms.

There are three advantages associated with our approach. First, since most existing research samples U.S. *Fortune* 500 firms, our aim is to conduct a replication with extension on China's large firms. By the late 1990s, while China's GDP led all emerging economies, its capital market capitalization represented approximately 10 percent of capitalization in all emerging economies (Xu and Wang, 1999: 79) and was the third largest in Asia after Japan and Hong Kong (Cha, 2001: 1). To the extent that science is a cumulative enterprise, the field needs more multinational extensions in order to make further progress (Hubbard *et al.*, 1998; Tsang and Kwan, 1999). Second, archival data on listed firms are more accessible than case or survey data typically used in many previous China studies. Finally, we take advantage of a unique window of opportunity, namely, the *first* 5 years (1992–96) during which an increasingly large number of firms were listed and outsiders appointed to boards.

Since the first year during which both exchanges were in full operation was 1992, initially we attempted to examine all firms listed during 1992–96 (inclusive). A complete search of the prospectuses and annual reports finds that only 405 of them reported complete information about board composition. Therefore, our sample is limited to these 405 firms (76% of the total). Sampled firms' industry distribution and ownership structure are broadly consistent with those of all listed firms. *t*-tests comparing the excluded and sampled firms indicate

no significant demographic differences, suggesting little systematic sampling bias. Because each year a number of newly listed firms were added, we have a total of 1211 company–year observations (see Table 2 for details).

### Board composition variables

Board composition variables are independently coded by four Chinese-speaking graduate assistants. Since firms whose information on board composition is unclear are already deleted, the assistants are able to reach a 99 percent agreement. All the remaining disagreements are resolved by consulting directly with the companies via local phone calls in Shanghai and Shenzhen during research visits to these cities.

Three steps are involved to identify 'outside directors.' First, a total of 52.1 percent directors are identified as insiders currently employed by the focal firm and its subsidiaries. Second, the remaining non-management directors are classified into three categories, representing (1) the state, (2) institutional (legal person) investors, and (3) individual investors. As discussed earlier, state directors, who represent 6.2 percent of all directors, are regarded as quasi-inside directors, and only directors representing institutional and individual interests meet our criteria of 'outside directors.' In particular, institutional directors are those representing domestic entities—called 'legal persons' by Chinese terminology—other than the state, the focal firm, and its subsidiaries. They represent 30.9 percent of all directors. Representing



10.8 percent of the directors, individual directors are those not related to the focal firm, government entities, or institutional investors. Overall, the average board has 9.8 directors, ranging from 5 to 19. Insider control is extensive, with only 26.3 percent of boards having more than half outside directors.

Finally, we examine whether the two types of outside directors are affiliated or not, by examining (1) whether they are family members of management, and (2) whether they have professional relationships with the firm (e.g., suppliers, buyers, banks, alliance partners). A recent World Bank study reports that unlike the rest of Asia (and emerging economies elsewhere), the ownership structure of listed companies in China, because of their SOE nature, is characterized by 'the absence of families as significant shareholders' (Tenev and Zhang, 2002: 103). Our data support this observation by finding only two cases of disclosed family relationships among individual directors and no such case among institutional directors.<sup>4</sup> We also find that almost all individual directors do not have professional relationships with the firm.<sup>5</sup> Further, 92 percent of institutional directors represent entities which have some identifiable professional relationships with the firm, thus becoming affiliated directors. Overall, using definitions established earlier, it seems reasonable to suggest that in general, institutional directors are *affiliated* outside directors, and that individual directors are *non-affiliated* outside directors.

After sorting out the directors (first in terms insiders vs. outsiders, second—among outsiders—in terms of institutional vs. individual directors, and finally in terms of affiliated vs. non-affiliated outsiders), to test Hypotheses 1a and 1b, we compute the proportion of outsiders on the board for each year. To test Hypotheses 2–5, we record the appointment of new outside directors for each year.

<sup>4</sup> We have to rely on disclosures of family relationships required by law, as opposed to directly investigating common family names. This is because relying on common family names may be a highly unreliable way of detecting family relationships, given that there are only approximately 200–300 commonly used family names in China. Although many people share some most commonly used family names (e.g., Chen, Wang), they may be totally unrelated at all.

<sup>5</sup> There is one exception of one director who worked at an accounting firm which audited the statements of the company.

### Firm performance variables

We choose two widely used accounting-based measures, return on equity (ROE) and sales growth, for three reasons. First, since capital markets in China are not well developed, volatile, market-based measures may not reflect firms' true performance. The turnover ratios of the Chinese stock exchanges are approximately 700–1000 percent vs. 67 percent in the United States (Xu and Wang, 1999: 85). The average holding period lasts about 1–2 months in China vs. 18 months in the United States. As a result, market-based measures in China tend to be less informationally efficient (Tenev and Zhang, 2002). Second, Chinese practitioners and officials attach great importance to ROE. Since 1996, CSRC has required that in order to qualify for a new listing, a firm's ROE has to be no less than 10 percent in each of the three most recent years. For a firm already listed, its ROE has to be positive in 1 of every 3 consecutive years; otherwise, it would be delisted. Operationally, we obtain ROE by using net income divided by the average of owners' equity during a given year (Qi *et al.*, 2000; Tian and Lau, 2001; Wang, 1998).<sup>6</sup> Finally, since a single measure such as ROE may be inadequate, we use a second measure, sales growth (annual growth of total revenue), to triangulate the important construct of firm performance. Theoretically, ROE is a financial measure that agency theory is more concerned with, and sales growth represents resource inflows closer to the spirit of resource dependence theory.

### Other variables

*Prior performance* is measured by all previous years' ROE and sales growth. *Firm size* is measured by the logarithm of total assets. *Firm age* is based on the founding year of the listed firm.

*CEO duality*<sup>7</sup> (i.e., CEO is also board chair) may help establish strong, unambiguous leadership, but

<sup>6</sup> Although firms may receive some low- or zero-interest loans from state-owned banks, we have not added back interest because of the lack of reported data. However, to the extent that all sampled firms are joint-stock SOEs, any particular advantage obtained by one firm through these loans is likely to be cancelled out by similar loans provided to other firms.

<sup>7</sup> CEO duality and all other variables described below are control variables. While we try to include as comprehensive a set of controls as possible, we do not include ownership variables (i.e., equity held by institutional and individual investors), for two reasons. First, including both directors and ownership shares

it may also promote CEO entrenchment (Daily and Dalton, 1994). Given the complex, unresolved relationship between CEO duality and board vigilance (Finkelstein and D'Aveni, 1994) and firm performance (Boyd, 1995; Tian and Lau, 2001), we include CEO duality as a dummy variable.

*Inside director shares* have been argued as a possible remedy to align the interests of managers and shareholders (Shleifer and Vishny, 1997). For instance, in the Czech Republic, Hingorani, Lehn, and Makhija (1997) find increased demand in share auctions when insiders hold more equity. But on the other hand, a high level of management ownership may result in entrenchment, as documented in countries such as Russia (Buck *et al.*, 1999; Peng *et al.*, 2003). Because of the difficulty in predicting *a priori* the performance impact of inside director ownership, which is low (approximately 0.4% on average in our sample), we include it as a control.

*Outside director shares*, according to agency theory, may presumably lead to board vigilance. Accordingly, we code the percentage of shares held by outside directors, which is also low (approximately 0.3%).

*State shares*, although not typically included in existing work in the West, are important for two reasons. First, all sampled firms are transformed SOEs, in which the state on average still held approximately 39 percent equity. Second, the role of state ownership during the transitions is unclear. The traditional view on state ownership is negative, as reported by Claessens and Djankov (1999) in the Czech Republic and Xu and Wang (1999) in China. On the other hand, during uncertain transitions, as Hingorani *et al.* (1997) find in the Czech Republic, the government may signal its interest to help certain firms by holding substantial equity stake (i.e., retaining the 'crown jewels'). Because these two contrasting views make it difficult to predict the impact of state ownership on performance during institutional transitions, state ownership is controlled.

*State directors*, measured by their percentage among all the directors, are also included.

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of these two groups of outside investors may tap into the same underlying dimension of 'outside investor influence,' resulting in multicollinearity problems. Second, Qi *et al.* (2000) and Xu and Wang (1999) have already established a positive relationship between shares held by institutional investors and firm performance, but they have not explored the impact of board variables. Therefore, we exclude ownership variables and choose to concentrate on board variables in this study.

*Industries* are broadly controlled using dummy variables to indicate whether a firm belongs to one of the six main industry groups classified by the stock exchanges, namely, manufacturing, conglomerate, distribution, real estate/properties, public utilities, and banking/financial industries.

### Analytical approach

To test Hypotheses 1a and 1b, we use a weighted generalized least-squares procedure. In the strictest sense, Hypothesis 1b must always be false, because no two real-world measures have zero correlations between them. Cohen (1992), however, argues that a hypothesis such as Hypothesis 1b can be accepted when the relationship between two variables is found, using a power analysis, to be trivial. Specifically, a relationship becomes 'trivial' when the sample size is sufficient for the risk of Type II error  $\beta$  to be equal to the commonly accepted Type I error risk of  $\alpha$  of 0.05. In other words, a power analysis can determine a sample size needed to detect a nontrivial effect at  $\alpha = 0.05$  and a power of 0.95 (which translates to a  $\beta = 0.05$ ). In strategy research, this method has recently been used by Hubbard *et al.* (1998) and Lane, Cannella, and Lubatkin (1998). Following these precedents, we *conservatively* assume a medium effect size, that is, we do not require a large  $R^2$  to demonstrate significance. According to Cohen (1992: 157–158), when the assumed effect size is medium (i.e.,  $R^2 = 0.15$ ) and the desired power is 0.95, the minimum sample size to test a null hypothesis would be 67, well below our sample size. In other words, if we find the  $R^2$  to be smaller than 0.15, we would be unable to reject Hypothesis 1b.

To test Hypotheses 2–5, we use a proportional hazards regression model, renowned for its explicit incorporation of the timing of changes in a qualitative dependent variable (Tolbert and Zucker, 1983). The goal is to model the instantaneous transition rate, or the probability of transition from one discrete state  $j$  to another  $k$  over an infinitesimally small unit of time, expressed as:

$$h_{jk}(t) = \lim_{\Delta t \rightarrow 0} \frac{p_{jk}(t, t + \Delta t)}{\Delta t} \quad (1)$$

where  $p$  is the probability of a transition. Further, we employ partial likelihood estimations, which make weaker and hence more conservative assumptions than full likelihood models. This

model is:

$$h_{jk}(t|X) = h_0(t) \exp(\beta X) \quad (2)$$

where  $h(t)$  is the hazard function—in this case, the rate of moving from having no outside directors (0) to having some outsiders on the board (1).  $X$  is a vector of covariates,  $\beta$  is a vector of regression coefficients, and  $h_0(t)$  is a hazard function for a unit with  $X = 0$ .

## FINDINGS

Table 3 reports basic statistics for all the pooled variables. In Table 4, we first focus on the full sample of 1211 company-years in Models 1 and 2. Model 1 not only suggests that greater proportions of affiliated (mostly institutional) and non-affiliated (mostly individual) outside directors have little impact on ROE, but also notes that the adjusted  $R^2$  is only 0.06, below the necessary 0.15 required in our power analysis. Thus, Hypothesis 1b is unable to be rejected, while Hypothesis 1a is rejected. However, in Model 2, we find the opposite. While the proportion of non-affiliated directors continues to have little impact on sales growth, the proportion of affiliated directors appears to assert a significantly positive influence on sales growth ( $p < 0.01$ ) and the adjusted  $R^2$  has reached 0.21, thus partially supporting Hypothesis 1a while rejecting Hypothesis 1b.

Next, the robustness of these findings is investigated through a series of 1-year lagged models. In Models 3–10, we examine the impact of outside directors in year 1 (e.g., 1992) on performance in year 2 (e.g., 1993). Still, outside directors do not appear to have any significant impact on ROE, as evidenced by the lack of significant coefficients and the low adjusted  $R^2$  in Models 3, 5, 7, and 9 (the highest adjusted  $R^2$  is 0.11 in Model 3). However, affiliated directors in an earlier year consistently have a significantly positive impact on sales growth in a later year in Models 4, 6, 8, and 10. Overall, Table 4 suggests that whether outside directors matter for firm performance depends on the particular performance measure, and that the proportion of affiliated (mostly institutional) outside directors is significantly and positively correlated with sales growth.<sup>8</sup>

Table 5 reports the tests for Hypotheses 2–5. For each independent variable, the top row (B) shows the parameter estimate, the second row its standard error, and the third row the exponential raised to the power of the coefficient. The last row indicates the extent to which changes in the appointment of outside directors are induced by changes of the independent variable by one unit. When an independent variable has no effect, this value is 1.0. A value greater than 1.0 indicates a positive effect, whereas a value smaller than 1.0 suggests a negative effect. The findings provide strong support for Hypotheses 2, 3, and 4, but *only* during 1992–93 (Model 1). Such support significantly declines over time, thereby validating Hypothesis 5. Specifically, prior performance, size, and age are significant predictors for the appointment of outsiders during 1992–93, whereas the overall chi-square is highly significant ( $p < 0.006$ ). During 1993–94, the effect appears to be weaker but still significant, for all independent variables and the overall fit. The predictive power of the variables continues to drop during 1994–95 and then drops sharply during 1995–96. By the fourth period, none of Hypotheses 2, 3, and 4 is supported. It is clear that as the processes of appointing outsiders to the board intensify, the hypothesized firm-specific predictors become less relevant, thereby supporting Hypothesis 5.

Finally, it is interesting to note some interesting results about control variables shown in Table 4. First, firm size and age are inversely related to performance, suggesting that larger and older firms may have more agency conflicts. This is consistent with the evidence from the Czech studies by Claessens and Djankov (1999) and Hingorani *et al.* (1997). Second, consistent with Finkelstein and D'Aveni (1994) and Tian and Lau (2001) but in contrast to Daily and Dalton (1994), CEO duality has a positive impact on performance. A possible explanation can be found in Boyd (1995), who suggests that CEO duality may be more important for firms in turbulent environments, as China's transitions may be argued to be. Lastly, consistent with other Chinese (Qi *et al.*, 2000; Xu and Wang, 1999), Czech (Claessens and Djankov, 1999), and Russian (Buck *et al.*, 1999) studies, state ownership and state directors generally have a negative

<sup>8</sup> In addition, we have undertaken a series of robustness checks: (1) 2-, 3-, and 4-year lag models, (2) industry-based models, and

(3) models using newly listed firms going through initial public offerings (IPO) vs. non-IPO firms in a particular year. The results are all qualitatively similar.

Table 3. Means, standard deviations, and correlations of pooled data

Variables	Means	S.D.											
1. ROE	0.08	0.07											
2. Sales growth	0.12	0.11											
3. Affiliated outside directors	0.30	0.28											
4. Non-affiliated outside directors	0.11	0.15											
5. Firm size (log)	12.78	19.45											
6. Firm age	23.13	12.02											
7. Prior performance	0.13	0.11											
8. CEO duality	0.57	0.23											
9. Inside director shares	0.004	0.003											
10. Outside director shares	0.003	0.003											
11. State shares	0.39	0.27											
12. State directors	0.06	0.04											

  

Variables	1	2	3	4	5	6	7	8	9	10	11
1. ROE											
2. Sales growth	0.09*										
3. Affiliated outside directors	0.14*	0.04									
4. Non-affiliated outside directors	0.02	-0.01	0.02								
5. Firm size	-0.02	-0.10*	-0.06	0.05							
6. Firm age	-0.03	0.05	0.08	0.07	0.26**						
7. Prior performance	0.21**	0.38***	0.02	0.03	-0.08	-0.11*					
8. CEO duality	0.10	0.12*	0.05	-0.07	-0.08*	-0.07	0.17*				
9. Insider shares	0.01	-0.07	0.02	0.05	0.03	0.06	0.02	0.07			
10. Outsider shares	0.01	0.02	0.08	0.02	0.06	0.03	0.03	0.01	0.04		
11. State shares	-0.04	-0.10*	0.08	0.02	0.24**	0.19**	-0.11*	0.13*	0.05	0.01	
12. State directors	0.01	-0.02	0.06	0.01	0.21**	0.22**	-0.07	0.09*	0.07	0.02	0.31***

$N = 1,211$  company-years. \*  $p < 0.05$ ; \*\*  $p < 0.01$ ; \*\*\*  $p < 0.001$

Table 4. Standardized regression models for firm performance (Hypotheses 1a and 1b)

	(1) Full sample ROE	(2) Full sample sales growth	(3) 1992–93 ROE	(4) 1992–93 sales growth	(5) 1993–94 ROE	(6) 1993–94 sales growth	(7) 1994–95 ROE	(8) 1994–95 sales growth	(9) 1995–96 ROE	(10) 1995–96 sales growth
<i>Independent variables</i>										
Affiliated (mostly institutional) outside directors	0.05 (0.03)	0.13** (0.02)	0.03 (0.04)	0.22*** (0.11)	0.08 (0.12)	0.18** (0.07)	0.03 (0.04)	0.14** (0.10)	0.02 (0.02)	0.07* (0.02)
Non-affiliated (mostly individual) outside directors	0.02 (0.05)	0.05 (0.04)	0.01 (0.07)	0.03 (0.03)	0.08 (0.19)	0.03 (0.03)	0.07 (0.04)	–0.01 (0.02)	–0.03 (0.04)	0.04 (0.02)
<i>Control variables</i>										
Prior performance	0.17** (0.21)	0.18** (0.10)	0.13** (0.17)	0.28** (0.07)	0.15** (0.20)	0.17** (0.10)	0.23** (0.17)	0.30*** (0.13)	0.16** (0.18)	0.29*** (0.21)
Firm size	–0.07* (0.03)	–0.02 (0.02)	–0.06* (0.04)	–0.02 (0.03)	–0.04 (0.07)	–0.08* (0.04)	–0.07* (0.03)	–0.17** (0.03)	–0.08* (0.02)	–0.04 (0.03)
Firm age	–0.13*** (0.13)	0.03 (0.02)	–0.08* (0.07)	–0.03 (0.02)	–0.07* (0.12)	–0.02 (0.01)	0.04 (0.09)	0.03 (0.03)	–0.07* (0.11)	–0.09* (0.03)
CEO duality	0.12** (0.07)	0.10** (0.05)	0.09** (0.05)	0.09* (0.02)	0.10* (0.03)	0.12** (0.04)	0.11* (0.08)	0.09* (0.02)	0.08* (0.10)	0.08* (0.05)
Inside director shares	0.01 (0.02)	0.03 (0.02)	–0.02 (0.01)	0.00 (0.01)	–0.03 (0.03)	0.00 (0.01)	0.01 (0.04)	0.00 (0.02)	–0.07* (0.03)	–0.02 (0.02)
Outside director shares	0.01 (0.02)	0.01 (0.01)	0.04 (0.07)	0.03 (0.02)	0.03 (0.03)	0.02 (0.02)	–0.01 (0.05)	0.02 (0.02)	0.03 (0.07)	0.04 (0.05)
State shares	–0.07* (0.04)	–0.11** (0.06)	–0.10** (0.02)	–0.08* (0.06)	–0.04 (0.03)	–0.07* (0.03)	–0.06* (0.03)	–0.05 (0.02)	–0.11** (0.07)	–0.09* (0.08)
State directors	–0.03 (0.10)	–0.04 (0.03)	–0.04 (0.21)	–0.04 (0.03)	–0.07* (0.06)	–0.03 (0.02)	–0.07* (0.15)	–0.03 (0.03)	0.03 (0.11)	–0.11* (0.11)
Industry dummies	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Adjusted $R^2$	0.06	0.21	0.11	0.28	0.05	0.21	0.07	0.20	0.10	0.19
$F$	3.25*	7.36**	6.25**	6.15**	2.77*	3.09*	2.92*	3.08*	2.57*	1.30*
$N$ (company-year)	1,211	1,211	49	49	173	173	274	274	310	310

Standard errors are reported in the parentheses. \*  $p < 0.05$ ; \*\*  $p < 0.01$ ; \*\*\*  $p < 0.001$

Table 5. Proportion hazards models for outside directors' appearance (Hypotheses 2, 3, 4, and 5)

Variables (hypothesized sign)		(1) 1992–93	(2) 1993–94	(3) 1994–95	(4) 1995–96
Prior performance (–)	<i>B</i>	–0.47**	–0.41**	–0.38*	–0.08
	SE	0.32	0.25	0.16	0.17
	exp( <i>B</i> )	0.91	0.92	0.88	0.93
Firm size (+)	<i>B</i>	0.12***	0.06**	0.02	0.04
	SE	0.06	0.03	0.07	0.03
	exp( <i>B</i> )	1.14	1.07	1.01	1.02
Firm age (–)	<i>B</i>	–0.38***	–0.21*	–0.07	–0.05
	SE	0.70	0.14	0.20	0.17
	exp( <i>B</i> )	0.87	0.79	0.93	0.99
–2 Logarithmic likelihood		96.58	157.76	114.07	68.73
Model $\chi^2$		41.39	17.55	13.08	4.18
<i>p</i> <		0.006***	0.03*	0.11	0.39
Model D		0.55	0.43	0.36	0.15
<i>N</i> (company–year)		49	173	274	310

*B*, coefficient; SE, standard error; exp (*B*), exponential raised to the power of *B*. \* *p* < 0.05; \*\* *p* < 0.01; \*\*\* *p* < 0.001

impact on performance. While not a focus of the present study, these variables clearly need to be examined more thoroughly in future work.

## DISCUSSION

### Contributions

As an initial probe into the important relationship between outside directors and firm performance during institutional transitions in China, this article makes two sets of theoretical and empirical contributions. Theoretically, we move beyond the typical, agency theory approach, by integrating the insights from three theories. For agency theory-based work, this study contributes to the literature by replicating and extending previous research in a new institutional context. Although replications are crucial for establishing the reliability, validity, and generalizability of previous findings, there is a paucity of replication in strategy research. While one may question whether this study is a 'fair' replication given the institutional differences, it is important to note that there has been no strict replication in social science research (Tsang and Kwan, 1999) and that *all* the small number of strategy replications reported by Hubbard *et al.* (1998) are replications with extension. To the extent that agency theory is accepted by scholars and officials in China, we believe that it is important to test its key hypothesis on the positive role of outside directors in a previously uninvestigated setting.

Resource dependence theory adds that not all outside directors are likely to have a positive impact on performance. Our findings suggest that only affiliated (mostly institutional) directors play a positive role here, and that their contributions only focus on one aspect of performance: sales growth. In contrast, non-affiliated (mostly individual) investors have no influence on performance. These findings clearly speak to the resource dependence proposition that only resource-rich outsiders such as institutional directors are likely to contribute to firm performance, and that resource-poor outsiders such as individual directors, despite their presumed incentive to influence management per agency theory logic, may be unable to contribute. The types of resources institutional directors bring may include intangible reputation and legitimacy as well as tangible contracts and projects (Au *et al.*, 2000; Peng *et al.*, 2001; Young *et al.*, 2001).

The legitimacy-seeking imperatives highlighted by institutional theory are well documented by the norm-formation processes during which various firms appoint outside directors. What is interesting and perhaps unique is that these processes, which took several decades in the United States to unfold, took place in a short span of 5 years in China. China's collectivist culture, which values norm conformity, may have accelerated these processes. The active intervention of the state (e.g., the ROE focus) may also play a role compelling firms to at least appear to be consistent with institutional expectations (Peng, 2000, 2003).

Empirically, first, this article takes advantage of a unique window of opportunity. With the appearance of a legislative 'pillar' for the institutionalization of introducing outside directors since 2001, the opportunity to study the factors behind the *voluntary* conformity is no longer available. Second, we highlight the needs to focus on particular performance measures. Essentially, our results indicate that ROE and sales growth may tap into different underlying dimensions of firm performance. Consistent with Park and Luo (2001), our findings that affiliated outside directors contribute to sales growth but not ROE implies that these directors may be more important in establishing external relations to make sales than to ensure a higher level of financial performance. Finally, this study leverages accessible archival data, thus generating robust findings on outside directors' roles broadly consistent with Keister (2000) and Peng and Luo (2000) in China as well as Boyd (1990), Carpenter and Westphal (2001), and Hillman *et al.* (2000) in the United States.

Overall, this article adds to a small but expanding stream of research on corporate governance with a focus on board dynamics in emerging economies going through institutional transitions (Young *et al.*, 2002), such as Hong Kong (Au *et al.*, 2000), Russia (Peng *et al.*, 2003), and Thailand (Peng *et al.*, 2001). Interestingly, while agency theory hypotheses typically fail to be supported in these settings, resource dependence and institutional claims tend to be substantiated.

### Limitations and future research directions

Despite a lack of support for agency theory predictions, we would not argue that this study provides a definitive test of agency theory during institutional transitions. One potential limitation is our sampling period (1992–96), during which capital markets were barely functional in China. While our findings provide a useful baseline for future work, we speculate that under two scenarios agency theory may find more empirical support. The first is simply the passage of time, because if outside directors are given enough time they may be able to play a more positive role. Second, several U.S. studies find that agency predictions are likely to be valid *only* when managers' interests are directly at stake, such as during acquisitions (Finkelstein and D'Aveni, 1994; Lane *et al.*,

1998). Therefore, we infer that the current lack of support for agency predictions may be a result of the lack of strong capital market disciplines in China. When the market for corporate control is sufficiently developed and managers and directors' careers are threatened, outside directors may be compelled to be more vigilant, thus possibly leading to stronger support for agency theory.

Another limitation is that our reliance on archival data results in less information about the internal workings of the board. There are two critiques on our approach. First, arguments have been made that perhaps no director is truly independent in China (Tenev and Zhang, 2002: 90–91). Second, recent scandals in the United States indicate that even companies with 'stellar' credentials in terms of having a majority of nominally independent directors on the board (on average 74% of outside directors at Enron, Global Crossing, Qwest, Tyco, and WorldCom in the year before their scandals erupted) can still be plagued by significant governance and performance problems (Finkelstein and Mooney, 2003: 103). It appears that more concrete information about the relational dynamics of board–CEO and insider–outsider relationships, as opposed to simple measures of outsider–insider ratios, may lead to a better understanding (Westphal, 1999; Young *et al.*, 2001). Another interesting extension may focus on board committees, which are a more recent new practice in China. Only 16 percent of the listed firms had committees by the end of 1997 (Gu *et al.*, 1999: 147).

Finally, while we are reasonably confident that the findings are generalizable to listed firms within China, given that most listed firms are still SOEs, we are not sure whether they can be generalized to non-listed firms which may have different ownership structures (Peng, Tan, and Tong, 2004). On one hand, listed firms—having survived a screening process—presumably are better managed. On the other hand, their large size may result in more agency conflicts, inertia, and slack (Tan and Peng, 2003). Due to data constraints, we are unable to identify whether the founding year of our sampled firms is that of the newer, listed entities or that of the older, traditional SOEs which may now become parent companies of the listed entities. These issues need to be clarified and explored further in China and other contexts going through institutional transitions.

### Policy implications

To the best of our knowledge, this article represents one of the first studies to rigorously examine whether outside directors actually positively affect firm performance during institutional transitions. Given the agency theory focus on *financial* performance, our answer is a clear 'No.' Apparently consistent conviction of many scholars and officials in China and elsewhere regarding a positive connection does *not* establish such a link. Similar to our findings from Russia (Peng *et al.*, 2003), our findings from China cast doubts on the hope that requiring outsiders on the board will help improve financial performance. If anything, widespread (and now universal) appointment of outsiders to the board may actually *lessen* their importance.

For policy-makers and practitioners in China and elsewhere, this article calls for more attention on the actual role played by outside directors. Although the control and monitoring role hypothesized by agency theory is endorsed by CSRC (2001), we find that certain outside directors seem to focus more on their resource dependence role. Although sales growth and ROE are moderately correlated ( $p < 0.05$ ) and increasing sales growth may eventually translate into better ROE, strong sales growth may also be the result of empire-building, excessive diversification, and legacies of central planning which value output as opposed to financial returns.

Three additional insights may yield further improvements. First, the high level of incontestable state ownership (on average 39% in the sample) has a negative impact on performance, and discourages outside directors to push for more restructuring. Cutting further ties with the state appears imperative. Second, increasing inside and outside director ownership (only 0.3–0.4% in our sample) may provide directors with more incentive. The last and perhaps more significant insight is that boards are only one component of a larger governance 'package' consisting of internal and external mechanisms (Walsh and Seward, 1990). While improving board effectiveness enhances internal mechanisms, external governance mechanisms need to be strengthened as well (Young *et al.*, 2002). At present, external mechanisms are relatively weak. In the long run, financial institutional investors such as investment and pension funds, which have not made much

impact in emerging economies, may accumulate more shares, demand board representation, and become more assertive (Khanna and Palepu, 2000; Ramaswamy *et al.*, 2002).

### CONCLUSION

Overall, our findings suggest that despite agency theory's theoretical logic and policy influence, whether certain governance practices recommended by the theory such as appointing outsiders to the board lead to better financial performance needs to be *empirically* determined. In light of the globally mixed findings in the West and the new corroborative findings from emerging economies such as China, it seems imperative that scholars draw upon the rich insights of other perspectives such as resource dependence and institutional theories when probing into the intriguing relationship between board composition and firm performance during institutional transitions.

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