

# **The Effects of Independent Non-Executive Directors (INED) on Company Performance — A Comparison of H-Shares and Red Chips Companies**

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*This study will examine the influence of and relationship between independent non-executive directors (INEDs) and the performance of non-state-owned enterprises (NSOEs) and state-owned enterprises (SOEs) businesses listed on the Hong Kong Stock Exchange (SEHK). It is well known and reported that the number of Chinese companies coming to Hong Kong for listing on the SEHK has increased since the first listing of H-share company Tsingtao Brewery Co Ltd (00168.HK) in 1993. As the market capitalisation and influence in Hong Kong of these companies has increased in the last 20 years, the effects of their performance have received more attention. It is important to examine whether an increase in the number of independent non-executive directors (INEDs) will influence the behavior of major shareholders and the performance of state-owned enterprises (SOEs). This study aims to assist policymakers and regulators in assessing the need for further revisions to the current INED policy. Additionally, the findings may be applicable to other emerging markets and regions around the world that feature SOEs.*

*Keywords: independent directors, board structure, company performance, state-owned enterprises*

## **INTRODUCTION**

Following the previous study by Li, Ho, and Poon (2021) and Li and Ho (2024) on the influence and relationship between independent non-executive directors (INEDs) and the performance of firms listed on the Hong Kong Stock Exchange (SEHK), this research aims to analyze the effects of changes in corporate governance and the emergence of stringent INED requirements imposed by the SEHK, particularly concerning SOE/H shares and red chips companies in Hong Kong.

Given the mixed findings regarding the impact of independent directors on firm performance—ranging from no correlation to both positive and negative effects—this study will further investigate how independent directors influence the performance of different types of listed companies in Hong Kong (Li, Ho, & Poon, 2021). Specifically, it will focus on a classification of companies based on Chinese companies

between H shares/ state-owned enterprises (SOEs) and red chip companies, which will be explored in details.

The findings of this research are expected to significantly contribute to the continuing reform of corporate governance policy, particularly in the development of board composition regulations set forth by the Hong Kong financial authorities and SEHK. This is especially relevant for understanding the dynamics between H shares/ state-owned enterprises (SOEs) businesses in Hong Kong and beyond.

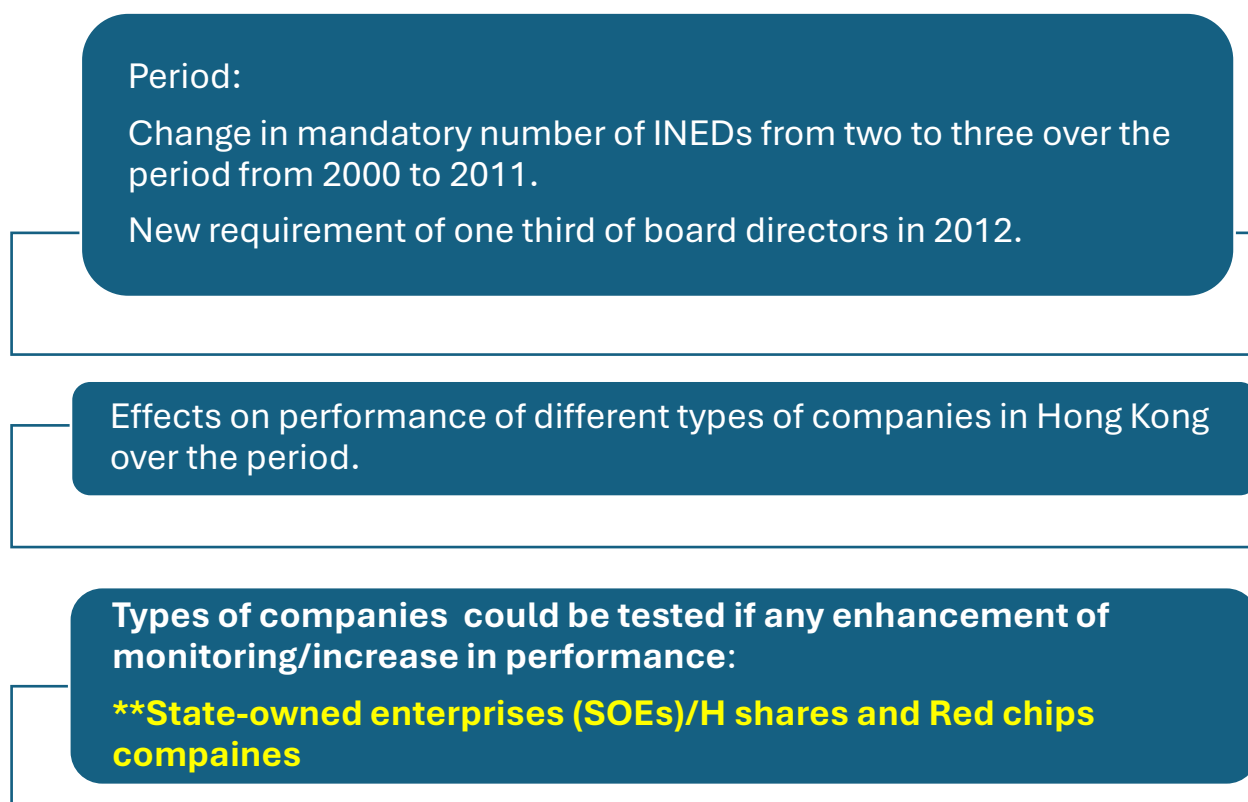
Following the introduction in Section 1, Section 2 will revisit the relevant literature and research methodology. Section 3 will review the empirical model and data, while Section 4 will present the study's results. Finally, the conclusion will be provided in the last section.

## LITERATURE AND METHODOLOGY

The literature reviewed in previous studies indicates that the relationship between independent directors and firm performance is inconclusive (Bhagat & Black, 2002; Chin-Jung & Ming-Je, 2007; Dulewicz & Herbert, 2004). Findings suggest that the impact of independent non-executive directors (INEDs) on the performance of companies in Hong Kong may vary, with effects that can be positive, negative, or non-correlated.

To illustrate the research framework of this study, Figure 1 (*reproduced*) summarizes the key components, including the study period, main research question, and the types of companies involved (Li, Ho, & Poon, 2021).

**FIGURE 1  
SUMMARY OF THE RESEARCH FRAMEWORK**



Li, Ho & Poon, 2021.

## Firm Performance Measurements and Performance Indicator Selection

As in the last paper, the same set of measures adopted include stock returns, return on assets (ROA), return on equity (ROE), Tobin's q (to measure firm valuation) and other measures such as economic value added (EVA).

According to the HKEx factsheet (dated 8 August 2013) on the listing of Chinese SOEs (H-share companies) in Hong Kong, only nine SOEs were approved to list on the SEHK on 6 October 1992 and started trading shares on 15 July 1993. More than 20 years passed for the first batch of Chinese companies to be listed in Hong Kong. The second batch of 22 companies was listed in Hong Kong on 27 January 1994. However, the HKEx had no right to choose which kinds of companies could be listed in Hong Kong at that time. Together with the SSE and SZSE, the CSRC determined which companies could be listed in the first two batches. Later, the selection criteria for listing were passed on to the market.

This paper considers the effects of INEDs on state-owned enterprises (SOEs)/ H shares and red chips firms.

## EMPIRICAL MODEL AND DATA

### Procedures for Choosing Panel Data Regression Methods (Reproduced From the Last Papers) (Li, Ho, & Poon, 2021)

*In this study all the available companies in the sample from SEHK listed companies are included (i.e., not a random sample). Hence, the fixed effects model was chosen and used for analysis.*

The effects of the main independent variable (INED) on the dependent variable (performance) are considered in the following panel regression model under the two group of classifications (H shares and Red chips firms).

$$Performance_{it} = \alpha + u_{it} + \beta_1 INEDR_{it} + \beta_2 FA_{it} + \beta_3 BS_t + \beta_4 DE_t + \beta_5 \log TA_{it} + \beta_6 \log Mkt_{it} + \beta_7 \log Debt_{it} + \beta_8 \log Equity_{it} + \varepsilon_{it} \quad (2)$$

where  $i = 1, 2, \dots, N$  and  $t = 1, 2, \dots, T$ .  $N$  is the total number of companies and  $T$  is the total number of periods.

The individual-specific intercept  $u_{it}$  controls for any combination of cross-section invariant variables that have been omitted (unobserved effects), knowingly or otherwise, from the regression model.  $Performance_{it}$  is one of the four commonly used performance variables considered, including stock return, Tobin's q, ROA and ROE. The INED ratio (INEDR) is the main independent variable considered. The other variables (board size, debt to equity ratio, total asset book value, market value of shares, total debt values and total equity values) are control variables.

### Sample Selection and Data Collection Procedures

*"The sample consists of Hong Kong firms incorporated and listed on the SEHK. A panel dataset is used, covering 2000-2011 inclusively. Therefore, the data cover a period before and after the mandate made at the end of the year 2004 requiring the presence of three INEDs on boards in Hong Kong. The minimum number of years of data for each firm is seven years with a maximum of twelve years. The mean is 11.4 years, generating a balanced panel dataset. After adjustments, the dataset provides 10,524 firm-year observations from 827 companies. The data were taken from several different sources. Company annual reports in the HKEx provided details for non-executive director representation. The reports also provided information related to board and institutional*

ownership. All the other performance data and control variables were taken from *DataStream*.” (Li, Ho & Poon, 2021).

### Variable Definitions

All variables are identified and defined in the following table.

**TABLE 1**  
**VARIABLE DEFINITIONS**

Variable	Definitions
Year	Year of the data
FA	Firm age of listing
P	Share price
STRN	Stock return
T	Tobin's q
TC	Change in Tobin's q
INEDR	Ratio of independent directors
INEDN	Number of independent directors
BS	Board size
ROE	Return on equity
ROA	Return on asset
DE	Debt to equity ratio
Mkt	Market value of shares
TA	Total asset book value
Debt	Total debt book value
Equity	Total equity book value
Rlp	Percentage change of stock return index (with capital gains and reinvestment of dividends)
logTA	Total asset book value, logarithm
logMkt	Market value of shares, logarithm
logDebt	Total debt book value, logarithm
logEquity	Total equity book value, logarithm

*Li, Ho & Poon, 2021.*

### Grouping and Classification of Companies

This study analyzes data from 877 companies in the database, covering the period from 2000 to 2011. This sample includes 151 Chinese companies and 726 non-Chinese companies.

All the companies are divided into two main groups/categories according to their Chinese/non-Chinese status. The Chinese companies are further divided into H shares and Red chips firms for study in details in this paper. Diagram 2 illustrates the grouping arrangements.

Given the classification of H shares and Red chips firms in the total population, the hypotheses must test whether and how INEDs could influence firm performance of Chinese companies.

In this paper, we have proposed the following hypotheses according to the literature review:

1. *The Hypothesis (H1) applies to all Hong Kong H Shares firms in general.*

**The Null Hypothesis (H0):** *Increasing the number of INEDs has positive effect on firm performance.*

**The Alternative Hypothesis (HA):** *Increasing the number of INEDs has no effect on firm performance*

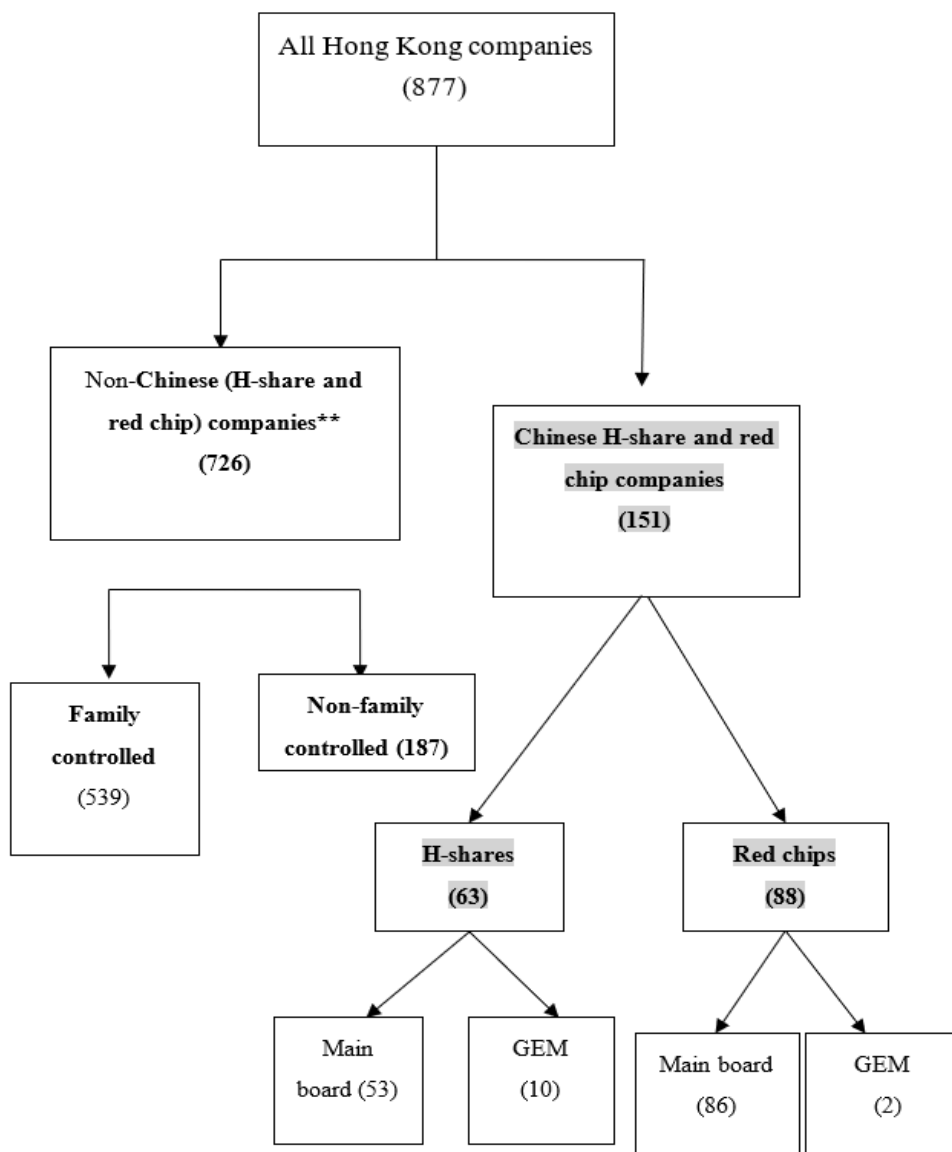
These hypotheses follow the understanding that an increase in the proportion of outside directors to strengthen board monitoring is likely to be effective in H shares /SOEs firms. (Ding, Jia, Wu, & Zhang, 2014) based on the literature review

2. The second Hypothesis (H2) applies to all red chips companies in general.

**The Null Hypothesis (H0):** Increasing the number of INEDs has positive effects on the performance of non-family-controlled companies.

**The Alternative Hypothesis (HA):** Increasing the number of INEDs has no effect on the performance.

**FIGURE 2**  
**DIFFERENT TYPES OF COMPANIES LISTED IN HONG KONG: CLASSIFICATION I**



Li, Ho & Poon, 2021

## RESULTS

The results of the H-share and red chip companies are discussed as follows.

### H-Share Companies

#### *Definition of H-Shares*

According to the HKEx definition, H-share companies are enterprises that are incorporated in the mainland and are controlled by either mainland government entities or individuals. In terms of descriptive statistics, the average time of listing is 8.14 years, the average number of INEDs is 3.14 and the INEDR is 33% during the period.

#### *Descriptive Statistics*

**TABLE 2**  
**DESCRIPTIVE STATISTICS OF H-SHARE COMPANIES IN HONG KONG**

Variable	Obs.	Mean	Std. Dev.	Min	Max
StockNo	819	1972.095	2742.813	38	8236
Year	819	2006	3.743944	2000	2012
FA	693	8.141414	4.082626	1	18
EPS	709	0.2345839	0.2953859	0	1.95
PE	651	39.78863	246.3739	1.4	6085
P	727	3.746396	5.549329	0.063	58.062
STRN	664	0.2379037	-0.6034636	.8501946 4	0.854766
T	103	1.200842	0.5499952	0.4961	4.0911
TC	93	0.0702866	-0.3607553	.6580502	1.096303
INEDR	706	0.3296114	0.1496886	0	1
INEDN	706	3.143059	1.720362	0	9
BS	756	8.615079	4.575343	0	22
ROE	638	0.1613943	0.2864869	.0003474	5.141729
ROA	744	0.0490444	-0.1130869	1.266073	1.460658
DE	659	1.259889	10.4162	.0001506	263.5343
Mkt	721	4.05E+07	1.80E+08	31344	2.380E+08
TA	744	4.86E+07	1.64E+08	43512	1.920E+08
NI	744	4379221	-2.06E+07	1.53e+07	1.970E+07
Debt	744	1.29E+07	3.52E+07	0	1.80E+07
Equity	744	2.34E+07	-9.02E+07	1.31e+07	1.00E+00
RIp	115	0.4802209	1.090816	-0.779	4.0316
TA	744	4.86E+07	1.64E+08	43512	1.920E+08
NI	744	4379221	-2.06E+07	1.53e+07	1.970E+07
Debt	744	1.29E+07	3.52E+07	0	3.180E+07
Equity	744	2.34E+07	-9.02E+07	1.31e+07	1.00E+00
RI	115	48.02209	109.0816	-77.9	403.16
RIp	115	0.4802209	1.090816	-0.779	4.0316

The empirical results associated with the effects of INEDs on the performance of H-share companies are given as follows.

**TABLE 3**  
**FIXED EFFECTS MODEL RESULTS FOR H-SHARE COMPANIES IN HONG KONG**

	Dependent variables				
	Stock return with reinvestment of dividend (RIp)	Stock return <sup>^^</sup> (STRN)	Change in Tobin's q	Return on equity (ROE)	Return on assets (ROA)
Ratio of independent directors (INEDR)	-1.972* (0.098)	-0.549** (0.021)	-0.774** (0.095)	-0.386 (0.323)	-0.020 (0.749)
Firm age (FA)	-0.045 (0.428)	-0.022* (0.090)	-0.009 (0.695)	0.050** (0.013)	0.003 (0.306)
Leverage ratio (DE)	0.233 (0.337)	-0.008*** (0.005)	0.000 (0.667)	0.002** (0.033)	0.000 (0.149)
Board size (BS)	0.020 (0.585)	-0.003 (0.785)	0.015 (0.267)	-0.013 (0.264)	0.004* (0.056)
Book value of equity, logarithm (logEquity)	-0.084 (0.851)	-0.422*** (0.000)	0.072 (0.676)	-0.264 (0.076)	0.006 (0.798)
Book value of debt, logarithm (logDebt)	0.241 (0.110)	-0.028 (0.351)	0.078 (0.190)	-0.051 (0.296)	-0.019** (0.021)
Book value of total assets, logarithm (logTA)	-1.505*** (0.002)	-0.175 (0.134)	-0.503*** (0.009)	-0.195 (0.221)	-0.056** (0.032)
Market value of equity, logarithm (logMkt)	1.194*** (0.000)	0.666*** (0.000)	0.309*** (0.000)	0.263*** (0.000)	0.037*** (0.000)

(\*\*\*, \*\* and \* represent significance at the 1%, 5% and 10% levels, respectively)

<sup>^^</sup>There are 819 firm-year observations from 63 H-share companies available since 2000. As not enough RI data (representative of stock returns with dividend reinvestment) were obtained from the database, simple stock returns (the variable STRN—the percentage of average price change) is used in the panel regression model instead.

#### *Discussion of the Empirical Results*

The effects of INEDs on stock return performance for the H-share companies are **negative** in general (-0.55% at the 5% significance level using the fixed effects model and with control variables added).

The results remain significant when Tobin's q is used as the performance variable, but not when ROE or ROA is used.

Analysis is as follows: Government control over a board has significant effects on firm performance. Firm performance decreases rather than increases when INEDs are added to the board. The effectiveness of INEDs on the boards of H-share companies is subject to debate. Furthermore, if the information/agency costs of the board are high, then the INEDs may not perform their roles as monitors or resource providers. As outsiders to the business, these INEDs need a substantial amount of firm-specific information to effectively perform their advising and monitoring duties.

In these politically controlled SOEs, there are significant costs involved in accessing this information. Hence, the INEDs may not function effectively on boards and may even decrease firm performance when added (Armstrong, Core, & Guay, 2013). Another problem relates to how 'independent' these INEDs are. Their effectiveness decreases when they are appointed by the company or have personal relationships with management. Furthermore, if management believes that an INED could monitor its actions or decisions

more extensively, then management or other board members may be unwilling to supply the necessary information related to their actions.

### Red Chip Companies

According to the HKEx definition, red chip companies are incorporated outside of the mainland China and are controlled by mainland local government entities. Red chip companies are listed on the SEHK. Red chip stocks are expected to meet the filing and reporting requirements of the exchange.

In terms of descriptive statistics, the average time of listing is 12.15 years (more than that of H-share companies), the average number of INEDs is 2.86 (lower than H-share companies) and the INEDR is 33% (same as H-share companies) during the period.

### Descriptive Statistics

**TABLE 4**  
**DESCRIPTIVE STATISTICS OF RED CHIP COMPANIES IN HONG KONG**

Variable	Obs.	Mean	Std. Dev.	Min	Max
StockNo	1,144.00	793.40	1,201.78	31.00	8,128.00
Year	1,144.00	2,006.00	3.74	2,000	2,012
FA	1,030.00	12.15	6.10	1.00	38.00
EPS	1,045.00	0.29	0.61	-	6.33
PE	854.00	36.88	215.74	-	5,936.70
P	1,048.00	4.40	8.97	0.09	101.38
STRN	1,037.00	0.20	0.78	(0.89)	7.98
T	1,036.00	1.91	9.61	0.20	292.05
INEDR	1,022.00	0.33	0.15	-	1.00
INEDN	1,022.00	2.86	1.19	-	7.00
BS	1,056.00	9.05	4.39	-	22.00
ROE	783.00	0.19	0.54	0.00	9.95
ROA	1,046.00	(0.01)	0.56	(11.38)	3.84
DE	1,045.00	43.48	324.30	(9,049.79)	3,658.22
Mkt	1,036.00	27,600,000.00	149,000,000.00	19,637.00	2,760,000,000.00
TA	1,046.00	33,000,000.00	137,000,000.00	1,605.00	1,740,000,000.00
NI	1,048.00	2,376,687.00	14,000,000.00	(10,800,000.00)	196,000,000.00
Debt	1,045.00	5,404,105.00	21,000,000.00	-	388,000,000.00
Equity	1,047.00	12,500,000.00	51,100,000.00	(663,853.00)	801,000,000.00
Rlp	1,032.00	0.32	1.17	(0.96)	16.28

There are 1,144 firm-year observations from 88 red chip companies available since 2000.

**TABLE 5**  
**FIXED EFFECTS MODEL RESULTS FOR RED CHIP COMPANIES IN HONG KONG**

	Dependent variables			
	Stock return with reinvestment of dividend (RI)	Change in Tobin's q	Return on equity (ROE)	Return on assets (ROA)
Ratio of independent directors (INEDR)	-0.073 (0.801)	0.006 (0.970)	0.053 (0.220)	0.017 (0.616)
Firm age (FA)	-0.017 (0.295)	-0.008 (0.365)	-0.001 (0.628)	0.000 (0.876)
Leverage ratio (DE)	-0.001*** (0.001)	0.000** (0.036)	0.000*** (0.000)	0.000*** (0.003)
Board size (BS)	0.000 (0.998)	0.005 (0.502)	0.002 (0.322)	0.000 (0.894)
Book value of equity, logarithm (logEquity)	-0.583*** (0.000)	-0.103 (0.109)	-0.179*** (0.000)	0.079*** (0.000)
Book value of debt, logarithm (logDebt)	-0.091*** (0.016)	-0.016 (0.407)	-0.021*** (0.001)	-0.005 (0.296)
Book value of total assets, logarithm (logTA)	-0.060 (0.657)	-0.284*** (0.000)	0.138*** (0.000)	-0.046*** (0.004)
Market value of equity, logarithm (logMkt)	0.886*** (0.000)	0.402*** (0.000)	0.049*** (0.000)	0.015*** (0.014)

(\*\*\*, \*\* and \* represent significance at the 1%, 5% and 10% levels, respectively)

All of the effects of INEDs on stock return performance, Tobin's q, ROE and ROA are insignificant (but positive) in general using the fixed effects panel regression. Compared with H-share companies, the effects of INEDs on the performance of red chip companies are insignificant.

They are also insignificant when the same variables are used in random and mixed effects panel regressions.

One possible reason for this is that the influence of China government/officials on these red chip companies is **not as strong/active** as it is on the H-share companies listed in Hong Kong.

The degree of their control or political connection is not so strong that it has no negative effects on performance when compared with the H-share companies. In conclusion, INEDs have some positive but insignificant effects on the red chip companies, which means that their boards are more open to INEDs and more willing to provide information to them.

## SUMMARY

This paper presents the nature of the Chinese companies (both H-share and red chip companies) listed in Hong Kong, the history of the listing of these firms in Hong Kong and the effects of INEDs on their performance.

The results suggest that INEDs have negative effects on the performance of H-share companies in general but insignificant effects in general on the performance of red chip companies. This is probably due to the different nature and political connections of the controlling shareholders and the degree of effectiveness of the INEDs in these firms.

The effects of increasing the INED for all of the segments of companies in Hong Kong should be further reviewed.

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