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财务困境和非执行董事薪酬：来自中国的证据

Financial Distress and Non-Executive Director Compensation: Evidence from China

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LIST OF ABBREVIATIONS

Abbreviations	Description
NED	Non-executive directors
CEO	Chief executive officer
CSMAR Database	China Stock Market & Accounting Research Database
SOE	State Owned Enterprises
CSRC Database	China Securities Regulatory Commission Database

摘 要

本论文研究公司财务困境如何影响中国上市公司外部非执行董事（NED）的薪酬政策。同等薪酬水平下，处于财务困境中的公司常常会因为风险高而面临非执行董事缺位的问题。因此，处理财务困境中的公司会通过提高薪酬水平以吸引有能力的外部非执行董事，以帮助解决公司的财务困难。本文的研究结果支持上述理论假设。本文还研究了 NED 年龄如何影响 NED 的薪酬水平。结果显示，相对于非财务困境公司，处于财务困境中的公司提供更高的薪酬以吸引年轻的非执行董事，而年长的非执行董事拿到的增量薪酬相对较少。这些结果表明，解决财务困难，年轻 NED 的能力或许比年长 NED 的经验更重要。最后本文分析了公司性质的影响。研究发现，面对可能的财务危机，国有控股企业不会像民营企业那样通过提高薪酬水平来吸引外部执行董事以解决公司的财务困难。总之，本文研究表明外部非执行董事对中国企业咨询角色的重要性。

关键词：非执行董事（NED)；NED 薪酬；财务困境；中国证据

ABSTRACT

This study examines how financial distress of a firm will impact the non-executive director (NED) compensation within Chinese listed firms. Firms facing financial distress will find it challenging to attract NED to their board of directors. Therefore, this study finds evidence that such firms facing financial distress will increase NED remuneration so as to attract NED. This study also investigates how NED compensation varies with NED age. The results indicate that older NED receive a rather reduced compensation as compared to their younger counterparts. This paper's final investigation involves examing how state owned enterprises (SOE) facing financial distress compensate their NED. This research reveals that state owned enterprises do not necessarily face the same kind of pressure as private firms when it comes to attracting NED.

The implications of this study reveals the growing importance of NED within Chinese firms and how NED can be incentivised to assist in reducing agency problems. The results attained from this research provide valuable guidance as to how firms in China can properly structure their compensation policies as to increase the monitoring and advising efficiency of their NED. Even though this research finds that SOE facing financial distress do not necessarily experience the need to attract NED, it provides enlightenment for SOE to develop corporate governance structures that will maximize shareholders wealth.

Keywords: Non-executive directors (NED), NED compensation, Financial distress, China

1. INTRODUCTION

This study examines the association between non-executive directors (NED) compensation and firms facing financial distress in China's publicly traded firms. Chang et al. (2015) define a firm to be financially distressed when the firm is no longer able to meet its financial obligations and hence the firm is forced to undertake drastic actions to discharge its obligations. Under the agency framework, non-executive directors act as monitors, controllers and advisors of management on behalf of shareholders. They align the interests of management with that of the shareholders.

This paper posists the following assumption about firms facing financial distress in China. Firms facing financial distress are most likley to increase NED compensation so as to attract NED to their board of directors. Kang and Mitnik (2014), state that financial distress results in substantial costs on firms and brings about all-around changes in corporate structure and decision making. One of the major changes brought about by financial distress includes changes to NED compensation. Compensation policy is regarded as an important aspect of a firms' strategy when dealing with financial distress, through provisions that change managers' incentives, Gilson and Vetsuypens (1993). In the event of financial distress, it is expected that NED will suffer losses both in their compensation and personal reputation. NED are most likely to have their renumeration cut or defferred in the event of financial distress. Except for financial losses, an NED of a firm facing financial distress will most likely lose his or her managerial reputation which will result in a reduction of his or her future compensation or employability in a similar position. With this assumption that financial distress can cause considerable personal loss for NED, firms experiencing financial distress risk might have to offer higher levels of compensation to attract NED to their firms.

Next, this paper examines the relationship between NED compensation and NED age in firms facing financial distress. Consistent with a study done by Chang et al. (2015), this paper puts forth that the loss to be incurred by younger NED in terms of reputation and financial loss will be greater than older NED because they have more productive working years ahead of them which will be affected by them being on the board of directors in a financially distressed firm. In contrast to this, older NED will not suffer great losses for being an NED in a financially distressed firm as they have fewer working years left before their retirement. It can therefore be expected that the younger NED will require much more compensation compared to the older NED for sitting on the board of a financially distressed firm.

This papers final research question involves investigating the relationship between state owned enterprises (SOE) facing financial distress and NED compensation. Different from non-SOEs which will be pressured to attract NED in the face of financial distress, it is expected that SOE will not encounter such pressure to find new NED. A possible explanation for this scenario is that SOE consider NED to be government employees therefore the SOE may not necessarily see the need to adjust NED compensation to attract NED to the firm. This paper therefore expects that in the event the SOE faces financial distress NED compensation will not be increased to attract NED to the firm.

To test these research questions, this paper uses a sample consisting of 4932 firm observations from Chinese[1] listed firms. The sample period ranges from 2001 to 2014.

In line with the above mentioned research questions, this paper finds evidence of a positive and highly significant relationship between NED compensation and firms facing financial distress in Chinas' listed firms. Consistent with this paper's expectation, an increase in NED compensation is observed when the firms face financial distress. This research papers' results also find a significant and negative association between NED compensation and NED age. These findings offer support to the prediction that a lower compensation package is given to older NED as compared to the compensation package given to younger NED. This result is also similar to that got by Chang et al. (2015). The results relating to NED compensation and SOE facing financial

[1] This study investigates NED compensation and firms' financial distress in China's domestically listed firms. This study excludes firms listed in Hong Kong.

distress indicate a significant and negative relationship. This confirms that during financial distress SOE do not increase NED compensation as witnessed in non-SOE firms. It can thus be concluded that SOE do not face pressure to attract NED to their boards.

This paper makes a number of significant contributions to the already existing corporate governance literature both in China and worldwide. It fills a gap in the limited literature on NED compensation. Consistent with Chang et al. (2015), it also gives support to the relationship between NED compensation and NED age. It is also the first paper to examine the association between NED compensation and a firm’s financial distress in Chinese listed firms. Finally, this paper provides valuable insight for developing economies on how firms facing financial distress address the issue of compensating their NED.

The remainder of the paper is organized as follows. The next section, chapter two, consists of the literature review which describes financial distress and NED compensation within China. This is followed by the hypotheses development. Chapter three details a description of the sample and data source. It also includes the variable descriptions and descriptive statisitics. Chapter four highlights the methodology used and the results of the regression analysis. Robustness tests are also included. Chapter five discusses the conclusion.

2. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

2.1 Literature review

There is limited literature that explores non-executive directors (NED) compensation. With most literature focusing on CEO compensation, there is an apparent gap within the corporate governance literature with regards to NED compensation. NED play a vital role in reducing agency costs through the advising and monitoring of the firm’s senior management, thereby aligning shareholder interests with that of senior management.

The available literature on NED compensation that focuses on firm characteristics, and has found a positive relationship between non-executive director remuneration and firm size (Adams and Ferreira (2008), Brick, Palmon, and Wald (2006), Hempel and Fay (1994)). The literature also finds that NED compensation is positively associated with growth and investment opportunities Linn and Park (2005). There is also evidence of a positive relationship between executive pay and non-executive director remuneration (Boyd (1994), Brick et al. (2006)). Available theory and previous findings also suggest that many executives seek non-executive director positions for non-pecuniary reasons Fama and Jensen (1983), but do not assess what such non-pecuniary rewards may cost investors. However, none of the existing literature has examined the effects of financial distress on NED compensation. This paper will therefore be the first to examine this relationship and it will solely focus on Chinese listed firms as these firms represent a unique sample.

2.1.1 Financial distress

Chang et al (2015) define a firm to be financially distressed when the firm is no longer able to meet its financial obligations and hence the firm is forced to undertake drastic actions to discharge its obligations, such as file for bankruptcy, undergo a troubled debt restructuring, sell assets at “fire-sale” prices, or be acquired by a financially stronger firm.

According to Kang and Mitnik (2014), financial distress incites substantial costs on firms and brings about all-around changes in corporate structure and decision making. A subset of the changes brought about by financial distress includes changes to NED compensation. Compensation policy is regarded as an important aspect of a firms' strategy when dealing with financial distress, through provisions that change managers' incentives Gilson and Vetsuypens

(1993). In developed economies the financial distress of a firm is widely accepted as an important aspect for disciplining the behavior of top management in distressed firms Fan et al. (2013).

An examination of literature closely related to a firm's financial distress and the resulting NED compensation, by Kaplan and Reishus (1990) finds that executives at troubled firms were less likely to obtain incremental non-executive director appointments but the same executives were much less likely to leave their non-executive director positions.

2.1.2 Board of directors in China

Chinese publicly traded companies have a two-tier board which includes a main board of directors and a supervisory board of directors. These firms are required to have a minimum of 5 directors and a maximum of 19 directors. In line with Chinese regulations[2] as to the duties of the board of directors, Chen (2015) lists a number of responsibilities to be carried out by the board of directors. These duties include but are not limited to following: convening and carrying out the resolutions made at the shareholders' meetings; determining the operation plans and investment plans; working out the company's annual financial budget plans and final account plans; working out the company's plans on merger, division, change of the company type, dissolution; making decisions on hiring or dismissing the company's manager and his remuneration, etc.

Chen (2015) further notes that majority of the NED on the board of directors in Chinese firms are usually retired government officials and experienced executives from other companies. This trend is similar to that of developed of countries where the experience of managers from other companies and the political connections of former government servants are regarded as essential and advantageous to the firm having such NED on their boards of directors.

2.1.3 Non-executive directors in China

In theory, Coles et al. (2008) state that the main duty of NED[3] is to monitor senior management and also to act as advisors to the CEO. Before 2002 Chinese listed firms were not required by law to have NED on their board of directors. Allen et al. (2005) and Jingu (2007) detail how since the early 2000s China's public firms were under pressure from investors to reform. Conyon and He (2011) state that as result of the ongoing pressure, Chinese listed firms have began to adopt

[2] Listed firms with a board have the major decisions made by the board and ratified by the shareholders.

[3] The corporate governance code defines director independence as: "The independent director shall be independent from the listed company that employs them and the company's major shareholders. An independent director cannot (i) be related to the manager, (ii) be one of the top 10 shareholders or hold more than 1% of the company shares, or (iii) have a business relationship with the firm Jiang and Kim (2015).

Western corporate governance models, with particular reforms focusing on the board of directors. An example of this is the Code of Corporate Governance issued by the China Securities Regulatory Commission (CSRC, 2002a). One of the important features of this code requires listed firms to include independent directors to their board of directors. The regulations therefore state that at least one-third of the board of directors should consist of NED. As is consistent with corporate governance literature, the addition of NED to the board will increase monitoring of managers therefore reducing the agency costs and aligning shareholders interests with that of the managers. It is therefore expected that a firm will therefore increase the number of NED if the marginal benefit from monitoring and advising exceeds the marginal cost resulting from information acquisition and communication. However, according to Jiang et al. (2015), in the case with Chinese firms, most firms will only maintain the minimum number of NED as required by regulation. Irrespective of this we expect to witness a significant change in NED[4] compensation if the firm faces financial distress.

2.1.4 Non-executive directors compensation in China

In the years preceeding 2001, Chinese listed firms were not required to disclose executive compensation information, though some firms voluntarily reported their executive renumeration figures. In 2001 the Chinese Securities Regulation Committee (CSRC) stipulated that all listed firms disclose the sum of total compensation for the three highest-paid management and the three highest paid board members. This regulation was ammended in 2006 and the CSRC expects all listed firms to disclose the renumeration received by each individual board member and senior management. The CSRC also prohibits the use of stock options[5] as a form of payment to independent directors. This paper uses a sample of listed firms starting from the year 2001 when data on NED compensation and executive compensation became publicly available. It can also be concluded that NED compensation is in the form of salary and bonuses. So for the puposes of this research, the total renumeration figure per firm of all NED in the firm will be the sum of salary and bonuses received.

[4] The proportion of independent directors on the board is about one-third, so the non-independent State influenced directors can still have significant power and influence Conyon and He (2011)

[5] CSRC regulations, 2005a

2.1.5 Age and Distress

Prior studies on CEO cash compensation have found a significant positive relationship between CEO cash compensation and CEO age (Gibbons and Murphy, 1992). They find evidence of CEO cash compensation increasing as the CEO approaches 59 years of age after which the compensation begins to steadily reduce. This study expects a smilar relationship between NED compensation and NED age. However, for firms facing financial distress, this paper expects that older NED will receive a lower compensation premium as compared to the younger NED. Following a study done by Chang et al. (2015), this paper posits that the loss to be incurred by younger NED will be greater because they have more productive working years ahead of them which will be affected by loss of reputation due to being on the board of directors in a financially distressed firm. On the other hand, older NED will not be greatly affected by losses for being an NED in a financially distressed firm as they have fewer years remaining before their retirement. It can therefore be expected that the younger NED will require much more compensation compared to the older NED for sitting on the board of a financially distressed firm.

2.2 Hypothesis formulation

It is frequently argued that independent outside directors have more incentives to effectively monitor the CEO because they are less subject to CEO influence and have reputations to protect in the labor market (Fama and Jensen (1983) and Weisbach (1988)).

In the event of financial distress, it is expected that NED will suffer losses both in their compensation and personal reputation. NED are most likely to have their renumeration cut or defferred in the event of financial distress. Furthermore, apart from financial losses, an NED of a firm facing financial distress will lose his/her managerial reputation which will result in a reduction of his/her future compensation or employability in the position of non-executive director. This argument is further supported by Berk et al. (2010), and their findings reveal that financially distressed firms pay higher levels to their workers to compensate for losses that are associated with a firm facing financial distress. NED will therefore require a higher compensation package to sit on the board of fianaciallly distressed firm. With the view that financial distress can cause considerable personal loss for NED, firms experiencing financial distress risk might have to offer higher levels of compensation to attract NED to their firms.

In summary NED in finacially distressed firms are likely to suffer losses in terms of their compensation and reputation (that is, their future employment and compensation opportunities will