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Impact of Independent Director and Audit Committee on Corporate Performances: Evidence from Taiwan

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Abstract. In the process of operating company, a good corporate governance system is indispensable.Taiwan had been used to the dual board system (directorsand supervisors) before 2002. However, since the system did not seem to be exercised perfectly and a lot of corporate scandals kept on occurring in Taiwan,the official authority introduced the independent director system in 2002 andthe single board system (directors, independent directors and the audit committee) in 2006. Because the official authority does not enforce the companies to adopt single level board strictly, currently there are three types of board systems in Taiwan: (1) directors and supervisors; (2) directors, independent directors and supervisors; (3) directors, independent directors and the audit committee. Through our empirical tests, we find that adopting the independent directorsystem does generate a positive impact on a company's performance. However, if the company cancelsthe supervisor system and totally adopt the single board system, it may not result inbetter performance.Therefore, this study infers that supervisors system is necessary to exist, because the audit committee can not completely replace the supervisor's role.

Keywords: Independent Directors, Audit Committee, Single Board System, Dual Board System.

1. Introduction

Before February 2002, the companies in Taiwan adopted the dual board system which directors and supervisors were elected individually from shareholders' meeting. The directors own the power to exert the business, and the supervisors can monitor the directors exerting the business. After February 2002, the authority stipulated that, according to the regulation of Taiwan Stock Exchange and GreTai Securities Market, there should be two independent directors in the board, and one of them has to be the professional in accounting or financial background if the company wants to apply for becoming public listed company. The Securities Exchange Act revised at January 11, 2006 even pointed out that a public listed company should voluntarily set up independent directors. The authority asked the companies that the amount of independent directors should not be fewer than two and fewer than the one-fifth of the number of directors. However, the authority should ask companies to set up independent directors according to the scale, shareholders' structure, the character of the business of the company and other necessary situation (Securities Exchange Act § 14-2). The authority also passed the revised Securities Exchange Act and added the mechanism of independent directors and the audit committee. The revised one, Securities Exchange Act § 14-4, pointed out that companies should choose one of two systems: either the dual board system or the single board system by setting up an audit committee. Moreover, according to the revised Company Act, the new public listed companies should not elect supervisors anymore. Although the authority adopted a flexible attitude about stipulating existing public listed companies, it started to force the financial industry and the companies with paid-in capital over 10 billion NT dollars to set up independent directors. The authority obviously intends to change the internal monitoring system of companies from the original dual board system toward the single board system.

However, comparing with each other, none of the systems has absolute advantages or weakness, and they both possess their traits. Hence, the main purpose of this study is to examine which system brings the better performance for domestic companies by using all the public listed companies in Taiwan from 2002 to 2011. Our empirical results indicate that founding independent directors positively influence companies'

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performance. Nevertheless, if companies cancel the supervisor system to build the audit committee, their performance would not be better.

2. Literature Review and Hypotheses Development

2.1. Literature Review

Prior studies have found the positive relationship between the value of a company and the amount of supervisors. Shyy and Vijayaraghavan (1996) study the critical factors of adopting supervisor. They find that the better a company's performance is the higher the opportunity of their adopting supervisors is and the more valuable supervisors are. Zhuo (2005) finds that a company with more supervisors prefers choosing accounting firms with higher quality of auditing and performs better. Yu and Chou (1994) find that a company's performance is most related to the shareholdings proportion of directors, supervisors, managers and major shareholders. Kao and Qiu (2002) find that the higher proportion of the shares as collateral by directors and supervisors is, the lower the surplus information and the stock return of the company is.

As for the literature investigating the influence of independent directors on the performance of companies, most studies mainly focus on the proportion and the scale of the amount of independent directors. Kesner (1987) considers that the key of corporate governance is the transparency of information. Based on the degree of the disclosure of financial information, the higher the proportion of independent directors in the board of directors is, the stronger the involvement between the company and their financial risk is. Elliot and Jacobson (1994), Cotter et al. (1997), Chen and Jaggi (2000) and Huson et al. (2001) show that when the proportion of independent directors in a company's board is higher, the company'' performance is better. However, some studies point out that there is no relationship between the proportion of external directors and a company's performance (Hermalin and Weisbach, 1991; Klein, 1998). Besides, Agrawal and Knoeber (1996) and Bhagat and Black (1996) find there is a negative relationship between the proportion of independent directors and a company's performance. From above, we find no consistent conclusion about the influence of the scale of independent directors on a company's performance. That is, so far, the scholars cannot ensure whether the foundation of independent directors is evidently positively related to the performance of companies.

2.2. Hypotheses Development

In order to raise the effect of corporate governance, the government actively promoted the independent director mechanism to replace the original dual board system for almost ten years. Therefore, due to the aforementioned historical reason, three monitoring mechanisms are currently implemented in Taiwan domestic companies: the single board system, the dual board system, and the in-transit system that independent directors and supervisors co-exist. Which system is the most moderate mechanism in the business environment of Taiwan is the key issue that we want to explore.

Therefore, how is the result? Do independent directors bring in the positive effect for companies or do they only produce the cost? According to the literature review, no consistent evidence is obtained. Thus we develop Hypothesis 1:

Hypothesis 1: the proportion of independent directors is positively related to a company's performance.

In the period in which the single board system was transferred into the dual board system, the authority in Taiwan added the audit committee mechanism to strengthen independent directors' right since there is also a difference between the right of independent directors and the right of supervisors. However, how is the influence of the independent director that is also the member of the audit committee on a company's performance? The point is another key in this study. We therefore develop Hypothesis 2:

Hypothesis 2: An audit committee can raise the function of independent directors and increase a company's performance.

3. Research Method

3.1. Definitionof Variables

In this study, we examine whether the proportion of independent directors and the foundation of audit committee affect domestic companies' performance. The dependent variable, a company's performance, is evaluated by both accounting and market performance measures. Return on assets (ROA) and return on equity (ROE) are the two proxies for accounting performances, and Tobin's Q ((the market value of equity+ the book value of debts)/ (the book value of asset)) is the proxy for market performance.

The independent variables are divided into three kinds: key variables, control variables of corporate governance, and control variables of companies' characteristics. Three key variables are the proportion of independent directors (OUTSIDERS), the audit committee (AUDIT),and the number of supervisors (SUP). Nine control variables of corporate governance are the scale of the board of directors (BS), duality (DUAL), the proportion of equity pledge of directors and supervisors (PLEDGE), the proportion of the shareholdings of insiders (%INSIDE), the proportion of the shareholdings of domestic institutions (%INST_DOM%), the proportion of the shareholdings of foreign institutions (%INST_FOR%), the proportion of the shareholdings of outside block holders (%BLOCK), the proportion of the shareholdings of the government (%GOVER), deviation index (DEVIATION). Six control variables of companies' characteristics are debt ratio (LEV), size (Size), research and development expenses (RD), growth (Growth), information disclosure quality (REVISE), Industry (EIND).

3.2. Model

We study the influence of the proportion of independent directors on a company's performance. Does an independent director being a member in audit committee simultaneously affect a company's performance? The major regression model therefore is:

$$PRF= \alpha_0+\beta_1\ OUTSIDERS +\beta_2\ AUDIT +\beta_3\ SUP +\beta_4\ BS +\beta_5\ DUAL +\beta_6\ PLEDGE +\beta_7\%INSIDE +\beta_8\%INST\_DOM +\beta_9\%INST\_FOR +\beta_{10}\%BLOCK +\beta_{11}\%GOVER +\beta_{12}DEVIATION +\beta_{13}\ LEV +\beta_{14}\ SIZE +\beta_{15}\ RD +\beta_{16}\ GROWTH +\beta_{17}\ REVISE +\beta_{18}EIND + \varepsilon$$

where

PRF=ROA, ROE, and Tobin's Q.

What we interested are the coefficients on the proportion of independent directors (OUTSIDERS), the audit committee (AUDIT), and the number of supervisors (SUP), i.e. β_1,β_2, andβ_3.

3.3. Data Selection

Bringing in the independent director system in February 2002, the authority stipulates that there should be two independent directors at least in a board of directors and one of them should be in accounting or financial background. In addition, The Securities Exchange Act revised on January 11in 2006 accelerates the foundation of independent directors and audit committees of companies and makesthe single board system a role in the corporate governance in Taiwan. In this study, we exploit the public listed companies in all the industries in Taiwan in the period from 2002 to 2011 to be our sample companies and exclude the companies in financial industry and the companies with incomplete data. The variables in the study are obtained from Taiwan Economic Journal.

4. Empirical Results

Figure 1 shows the result without considering OUTSIDERS and AUDIT in the regression. The coefficients and significance of SUP in the regressions on ROA, ROE and Tobin's Q are respectively (0.01963***, 0.04430***, and 0.05262***). This result is consistent with Shyy et al. (1996) and Zhou (2005) that the number of supervisors is positive related to a company's performance.

Table1: Influence of supervisors on a company's performance

Key Variable	Sign	(1) *ROA*	(2) *ROE*	(3) TOBIN'S Q
SUP	+	0.01963***	0.04430***	0.05262***

Note1: All variables of corporate governance and companies' characteristics are controlled in the model but not provided in the figure.

Note 2: The sign *, ** and *** represents that the level of significance is up to 10%, 5% and 1% respectively.

We then further examine Hypothesis 1 and Hypothesis 2 by using different investigation periods. First, we use the whole sample data from 2002 to 2011 to run regression. Figure 2 shows the result. In the figure, we find the coefficients of OUTSIDERS are all significantly positive (0.09299***, 0.22269***, 0.74801 ***). Hence we can infer that higher proportion of independent directors results in a better company's performance. However, according to the coefficients of AUD (-0.00912, -0.08938***, -0.02653) found in Figure 2, we can infer that foundation of an audit committee cannot bring in benefit to a company and even harms its ROE. Hence, we conclude the foundation of an audit committee cannot increase the benefit that independent directors bring in.

Table 2: Influence of independent directors and an audit committee on a company's performance

Key Variables	Sign	(1) *ROA*	(2) *ROE*	(3) TOBIN'S Q
OUTSIDERS	+	0.09299***	0.22269***	0.74801***
AUDIT	+	-0.00912	-0.08938***	-0.02653
SUP	+	0.01889***	0.03464***	0.05210***

Note1: All variables of corporate governance and companies' characteristics are controlled in the model but not provided in the figure.

Note 2: The sign *, ** and *** represents that the level of significance is up to 10%, 5% and 1% respectively.

Next, due to the aforementioned historical reason, we examine the sample companies by dividing the sample period into two durations: 2002 to 2006 and 2007 to 2011. Since no audit committee was in companies in the period from 2002 to 2006, no *AUDIT* is in the regressions. According to Figure 3 and Figure 4, we find that the coefficients of OUTSIDERS on the three performance variables from 2002 to 2006 are all bigger than which in the period from 2007 to 2011. This is consistent with the result in Figure 2. Even if the coefficient of independent directors is significantly positive after considering audit committee, the coefficient of independent directors decreases. Hence, we conclude the foundation of an audit committee cannot increase the benefit that independent directors bring in.

Table 3: Influence of independent directors and an audit committee on a company's performance (2002 to 2006)

Key Variables	Sign	(1) *ROA*	(2) *ROE*	(3) TOBIN'S Q
OUTSIDERS	+	0.17792***	0.38247***	0.89591***
SUP	+	0.02107***	0.03790***	0.07585***

Note1: All variables of corporate governance and companies' characteristics are controlled in the model but not provided in the figure.

Note 2: The sign *, ** and *** represents that the level of significance is up to 10%, 5% and 1% respectively.

Table 4: Influence of independent directors and an audit committee on a company's performance (2007 to 2011)

Key Variables	Sign	(1) *ROA*	(2) *ROE*	(3) TOBIN'S Q
OUTSIDERS	+	0.06041***	0.15982***	0.71117***
AUDIT	+	-0.00317	-0.08741**	0.03917
SUP	+	0.01448***	0.02532***	0.03465

Note1: All variables of corporate governance and companies' characteristics are controlled in the model but not provided in the figure.

Note 2: The sign *, ** and *** represents that the level of significance is up to 10%, 5% and 1% respectively.

Based on our empirical findings, both independent directors and supervisors are good for a company's performance in a same time. The function of supervisor does not change due to the introduction of independent directors. These two cannot be replaced by each other, and both of them own their traits and functions on the corporate governance. However, even if a company adopts the single board system and add the audit committee to supplement insufficiencies of independent directors' function, the audit committee still cannot completely replace the function of supervisors. That is, the mechanism of supervisors is necessary to be maintained while the audit committee does not show its expected function. Under the condition that independent directors and supervisor can exist simultaneously and are positively related to a company's performance while the foundation of an audit committee cannot produce a positive effect to a company's performance, our empirical results depict that simultaneously building directors and supervisors is the most moderate mechanism for the companies in Taiwan.

5. Conclusion

In this study, our empirical results support Hypothesis 1 thatthe proportion of independent directors is positively related to a company's performance but do not support Hypothesis 2 that an audit committee can raise the function of independent directors and increase a company's performance. The evidence shows that the in-transit system, co-existence of independent directors and supervisors, is the best one among the three existing systems in Taiwan. In conclusion, our findings could be a helpful reference to the authority on whether completely implementing the single board system is appropriate for the corporate internal mechanism system in Taiwan.

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