

# Board Advising, Risk-Taking, and Firm Performance

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## Abstract

The corporate risk-taking has caught public attention due to the global financial crisis. Using a sample of listed companies in China from 2008 to 2015, this paper investigates how the role of board advising affects corporate risk-taking and the possible economics consequences of risk-taking. The empirical results show that the percentage of advisory directors is positively associated with the level of corporate risk-taking, and the interaction of the percentage of advisory directors and risk-taking is positively correlated with the future firm performance. However, these effects are not significant at all in the state-owned enterprises due to government's interference.

## Keywords

Risk-Taking, Board Advising, Firm Performance

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## 1. Introduction

The corporate risk-taking has caught public attention due to the global financial crisis for the past few years. The level of risk-taking reveals whether the managers would choose to invest a risky project. The higher level of risk-taking means that the managers prefer risky but value-enhancing investments, which will promote the progress of production technology (John et al., 2008). For one thing, managers do have the incentives to increase corporate risk-taking by undertaking risky investments, since there is a good chance to gain great rewards. For another, managers may avoid risky investments to protect their reputation and job position, which leads to low level of risk-taking of the company. Then what might have influence on the investment decision-making of the company and how would that affect corporate risk-taking? To study this issue, the previous literature has explored from ownership structure, executive incentives, executive characteristics as well as institutional background. Since board governance is the

core of corporate governance, the influence of the board on corporate risk-taking should be concerned. Therefore, this paper aims to research this issue from the perspective of board governance.

In addition to monitoring, another primary role of the board is advising. Directors who have advising experience or expertise dedicate to provide professional suggestions which help the managers to identify and evaluate potential opportunities and undertake some risky but value-enhancing investments. In that case, the level of corporate risk-taking is likely to increase. However, will this high level of risk-taking do harm to the future firm performance? Moreover, due to the special institutional background in China, the conclusion on this issue may vary widely.

Based on the above discussion, this paper develops four following assumptions: 1) The percentage of advisory directors is positively correlated with the level of risk-taking. 2) The positive correlation between advisory directors and risk-taking is stronger in non-state-owned enterprises. 3) Firm performance increases with the interaction of advisory directors and risk-taking. 4) The positive association between firm performance and the interaction of advisory directors and risk-taking is stronger in non-state-owned enterprises. To tests these hypotheses, this paper uses a sample of listed companies in China from 2008 to 2015. It is found that the increase of advisory directors raises the level of risk-taking and the interaction of advisory directors and risk-taking contributes to the improvement of firm performance. However, these effects are not significant at all in the state-owned enterprises due to the complicated government's interference.

This paper contributes to literature on the effectiveness of boards by providing insights on the advising role of the board. Furthermore, it riches the research of corporate risk-taking by studying the possible economic consequences of corporate risk-taking.

The rest of the paper is organized as follows. Section 2 provides discussion of literature and the development of hypotheses, followed by a discussion of construction of sample and variables in Section 3. The results and discussion are presented in Section 4. Section 5 concludes.

## **2. Literature Review and Hypotheses Development**

### **2.1. Literature Review**

#### **2.1.1. The Role of Board Advising and Advising Performance**

In addition to monitoring, another primary role of the board is advising (Baysinger & Hoskisson, 1990). Directors who have advising experience or expertise dedicate to provide professional suggestions which help the managers to identify and evaluate potential opportunities (Lorsch & Maciver, 1989). These directors, who are the key to play the role of advising, are classified as advisory directors (Gong & Mao, 2014).

Regarding the function of board advising, previous studies have found evidences on merge and acquisition, financing and R&D. Kim et al. studied the advising performance based on the tenure of outside director. They found that outside director tenure is positively correlated with firm acquisition performance and investment policy performance,

suggesting that directors in board also perform as an advisor (Kim et al., 2012). Sun Liang and Liu Chun pointed out that the non-state-owned enterprises in China tend to hire more nonlocal advisory directors to support decision-making process of the company (Sun & Liu, 2014). Liu et al. also found that with the support of nonlocal independent directors, acquisition is more efficient (Liu et al., 2015). Regarding financing performance, directors who have banking experience weaken the correlation between cash flow and investment, and increase their debt financing (Ramirez, 1995). He Qiang and Chen Song examined the relationship between the educational level of board of directors and R&D investment. They illustrated that with more Doctors in board, the company's R&D output can be improved (He & Chen, 2011).

### **2.1.2. Influence Factors of Risk-Taking and Economic Consequence**

Regarding influence factors of risk-taking, previous studies mainly focused on ownership structure (Li & Yu, 2012), characteristics of executives (Faccio et al., 2016), executives' incentive (Coles et al., 2006) and external institutional background (Hilary & Hui, 2009). Faccio et al. illustrated by empirical evidence that firms with higher degree of decentralization of the largest shareholder are more likely to undertake riskier investments (Faccio & Mura, 2011). Later, Boubakri et al. pointed out that the proportion of state-owned equity is negatively correlated with corporate risk-taking, while foreign ownership is positively associated with risk-taking (Boubakri et al., 2013). Female CEOs tend to avoid risky investment opportunities, leading the company to a low level of risk-taking (Faccio et al., 2012). Meanwhile, Kini and Williams found that tournament incentives can encourage executives to undertake riskier investments (Kini & Williams, 2012). As for external institutional background, Creditor protection affects investment choices, causing a lower level of risk-taking (Acharya et al., 2011).

As for the economic consequence of risk-taking, some of the studies believed that company can benefit from risk-taking. Positive risk-taking contributes to high growth rate, efficient capital allocation and high value of the company (Kreiser et al., 2002). However, other studies argued that radical risk-taking will lead to negative consequences. They believed risky financial decisions played an important role in causing or aggravating the 2007 financial crisis (Muller-Kahle & Lewellyn, 2011).

To sum up, the modern literature has reached a consensus on advising function of the board. Apart from merge and acquisition performance, R&D expenditure and financing, corporate risk-taking is another advising performance should be concerned. Therefore, this paper aims to examine the relationship between board advising and risk-taking.

## **2.2. Hypotheses Development**

### **2.2.1. Advisory Directors and the Level of Corporate Risk-Taking**

Advisory directors should have access to enough firm-specific knowledge before they can provide any advice for decision-making (Faleye et al., 2011). Given that the company can benefit from the strategic advice provided by advisory directors, managers are willing to trust advisory directors and have incentives to share firm-specific informa-

tion with them. Therefore, it is easy to assume that with more advisory directors in the board, there will be more relevant information for advisory directors to help CEOs carry out risk evaluation and investment selection. CEOs then have the incentives to pick risky but value-enhancing projects. As a result, the level of corporate risk-taking will increase. This paper predicts a positive association between advisory directors and the level of corporate risk-taking:

**H1.** The percentage of advisory directors is positively correlated with the level of risk-taking.

The state-owned enterprises in China are under interference from the government. The major decisions have to be reported to higher authorities to gain permission. In this case, the managers of these businesses tend to avoid riskier investment because such decision is easier to get through. Besides, state-owned enterprises are run for some special government function such as dealing with problem of employment, maintaining social stability as well as government supply (Shleifer & Vishny, 1994) managers, who are not motivated to gain profit for the company, are likely to stay at where they are to keep the job position and salary stable. This leads to the second hypothesis:

**H2.** Compared with the non-state-owned enterprises, the positive correlation between advisory directors and risk-taking is stronger in non-state-owned enterprises.

### **2.2.2. Advisory Directors and the Economic Consequences of Corporate Risk-Taking**

According to the recent studies, the relationship between risk-taking and firm performance cannot be generalized. Decision on investment is group decision-making behavior that requires the participation of all members in board of directors as well as comprehensive knowledge in various fields. Advisory directors usually have different knowledge structure and different working experience. The heterogeneity in group ensures that decisions made by the board are thoroughly considered and value-enhancing. With the support of advisory directors, not only the corporate risk-taking is raised to high level, but also lead the company to better future performance. This leads to the third hypothesis:

**H3.** Firm performance increases with the interaction of advisory directors and risk-taking.

Similarly, due to the very different decision-making process between state-owned enterprises and non-state-owned enterprises, the fourth hypothesis of the paper is:

**H4.** Compared with the non-state-owned enterprises, the positive association between firm performance and the interaction of advisory directors and risk-taking is stronger in non-state-owned enterprises.

## **3. Sample, Variables, and Descriptive Statistics**

### **3.1. Sample**

The initial sample of this paper consists of Shenzhen and Shanghai A-share listed companies from 2008 to 2015. In order to meet the demand of this study, companies as follows are eliminated from the sample.

- 1) Financial listed companies.
- 2) ST and PT companies.
- 3) Companies missing board structure or financial data.

The data comes from CSMAR database. Combined with China's national conditions, the CSMAR database is well designed and currently one of the most accurate financial and economic databases in China. It contains stocks, funds, bonds, derivatives, listed companies, economy, industry and high-frequency data, which allows to find biographical information of members in board of directors and construct variable to measure advisory directors.

Using these data, several variables are constructed to utilize in empirical tests, including measures of board structure and firm characteristics.

## 3.2. Variables

### 3.2.1. Dependent Variables

#### 1) Risk-taking

Similar to the one used in previous study (John et al., 2008), since riskier company operations always present more volatile returns to capital, the paper adopts market-adjusted volatility of firm-level earnings to measure corporate risk-taking.

$$\text{Risk\_taking}_{i,t} = \sqrt{\frac{1}{T-1} \sum_{t=1}^T \left( E_{i,t} - \frac{1}{T} \sum_{t=1}^T E_{i,t} \right)^2}$$

where

$$E_{i,t} = \frac{\text{EBITDA}_{i,t}}{\text{ASSETS}_{i,t}} - \frac{1}{N_{k,t}} \sum_{j=1}^{N_{k,t}} \frac{\text{EBITDA}_{j,t}}{\text{ASSETS}_{j,t}}$$

$i$  indexes firms and  $t$  indexes year.  $N_{k,t}$  indexes firm numbers within industry  $k$  and year  $t$ . For each firm with available earnings and total assets for at least 3 years in 2008 to 2015, the deviation of the firm's EBITDA/Assets from the industry average (for the corresponding year) is calculated and then the standard deviation of this measure for each firm is calculated.

#### 2) Firm performance

Generally, there are non-financial indicators and financial indicators that can be utilized to measure firm performance. Financial indicators, which includes return on total assets (ROA), return on equity (ROE), earnings per share, net profit and main business profit margins, are more stable and easier to attain but also easy to be manipulated. Non-financial indicators such as stock returns and Tobin's Q are not applicable since capital market in China is not developed. Following existing literature, this paper uses ROA to measure firm performance because it is a good measure of operating capacity of the firm's total assets (including liabilities).

### 3.3.2. Explanatory Variable

The explanatory variable this paper constructs is the percentage of advisory directors in

board of directors. According to the definition and classification of Gong Huifeng and Mao Ning, there are several considerations of the definition of advisory directors (Gong & Mao, 2014). First, board committees can be classified as either monitoring or advising. The most common standing advising committees are the finance, investment, strategy, and executive committees. Thus, directors who serve on any one of the advising committees are classified as advisory directors. Second, directors who used to be legal representatives, factory directors, CEOs, general managers and entrepreneurs, or have experience on venture capital investments are classified as advisory directors. Third, directors who are consultants, professors, researchers, doctors, engineers and analysts are classified as advisory directors.

### 3.3.3. Control Variables

Several variables are constructed to be control variables in empirical tests. Firm\_size is the natural log of total assets. Growth is the increase rate of business revenue. Lev is the ratio of total debt to total assets. Age is firm age measured in years. First is the proportion of outstanding shares owned by the largest shareholder. Dual equals one when the CEO also serves as board chair, zero otherwise. Board\_size is the natural log of the number of directors. Indep is the percentage of independent directors in board of directors. Besides, each regression includes year and industry dummies. The description of all variables is provided in Table 1.

### 3.3. Descriptive Statistics

Table 2 presents summary statistics for variables. The average level of risk-taking is 0.0465 and the standard deviation is 0.0564, suggesting that corporate risk-taking varies from each other. The sample firms earned a 4.37% return of assets (ROA) on average, which is comparable to most of the previous studies. Consistent with previous studies,

Table 1. List of variables.

Variable	Description
Risk-taking	Market-adjusted volatility of firm-level earnings
ROA	Return on total assets
Adv_dire	The percentage of advisory directors in board of directors
Firm_size	Natural log of total assets
Growth	The increase rate of business revenue
Lev	Ratio of total debt to total assets
Age	Firm age measured in years
First	The proportion of outstanding shares owned by the largest shareholder
Dual	Equals one when the CEO also serves as board chair, zero otherwise
Board_size	The natural log of the number of directors
Indep	The percentage of independent directors in board of directors

**Table 2.** Descriptive statistics of variables.

	Mean	Std	Min	25th	Median	75th	Max
Risk-taking	0.0465	0.0564	0.0003	0.0138	0.0268	0.054	0.4302
ROA	0.0437	0.0688	-0.2352	0.0142	0.0394	0.0724	0.2725
Adv_dire	0.461	0.1607	0.25	0.3461	0.5556	0.6667	0.7778
Firm_size	21.7066	1.3151	18.6968	20.8213	21.5784	22.4673	25.6517
Growth	0.2311	0.6625	-0.6798	-0.2447	0.1289	0.3064	5.0765
Lev	0.4911	0.2592	0.0467	0.311	0.4873	0.6446	1.6956
Age	2.5755	0.4096	1.0986	2.3979	2.6391	2.8904	3.2189
First	0.3638	0.1562	0.0894	0.2359	0.3436	0.4801	0.7668
Dual	0.2025	0.4019	0	0	0	0	1
Board_size	2.1807	0.1985	1.6094	2.0794	2.1972	2.1972	3.2581
Indep	0.3676	0.0519	0.3	0.3333	0.3333	0.4	0.5714

the average percentage of advisory directors is 46.1%, suggesting that there are quite a few directors who have advising experience, advising knowledge or serve on advising committees. 20.25% of the sample firms' CEOs also serve as board chairs and the proportion of outstanding shares owned by the largest shareholder is 36.38%. The average board has 9 ( $e^{2.1807}$ ) members, 36.76% of whom are independent directors.

### 3.4. Correlations

**Table 3** reports key correlations of variables. Adv\_dire is positively correlated with Risk-taking ( $p < 0.01$ ), which supports H1 and indicates that as the number of advisory director increases, the level of corporate risk-taking increases too. However, Risk-taking is not correlated with ROA when Adv\_dire is not involved. Therefore, in order to test H2, it's necessary to conduct further study on the relationship between corporate risk-taking and firm performance when advisory directors are involved. In addition, the correlation coefficients between the main variables are not larger than 0.388, which indicates that there is no serious multicollinearity between the variables in the model.

## 4. Empirical Results

### 4.1. Advisory Directors and the Level of Corporate Risk-Taking

To test H1 and H2, the paper uses the following model:

$$\text{Risk\_taking}_{i,t} = c + \alpha_1 \text{Adv\_dire}_{i,t} + \sum \beta_i \text{Control}_{i,t} + \varepsilon_{i,t}. \quad (1)$$

Control<sub>*i,t*</sub> refers to control variables, including Firm\_size, Growth, Lev, Age, First, Dual, Board\_size and Indep. It begins with the test of full sample, and then the full sample is separated into state-owned enterprises subsample and non-state-owned enterprises subsample to conduct another test using the same model.

**Table 3.** Correlations of variables.

	Risk-taking	ROA	Adv_dire	Firm_size	Growth	Lev	Age	First	Dual	Board_size
Risk-taking	1									
ROA	0.004	1								
Adv_dire	0.034***	0.055***	1							
Firm_size	0.068***	0.006	0.101***	1						
Growth	0.019**	0.199***	0.007	0.033***	1					
Lev	0.044***	0.388***	0.045***	0.296***	0.045***	1				
Age	0.037***	0.179***	0.096***	0.118***	-0.011	0.266***	1			
First	-0.008	0.110***	0.001	0.271***	0.061***	-0.001	0.177***	1		
Dual	0.003	0.065***	-0.008	0.185***	-0.006	0.158***	0.120***	0.058***	1	
Board_size	0.007	0.004	-0.004	0.286***	0.017**	0.115***	0.035***	0.016**	0.167***	1
Indep	0.017**	0.014*	0.058***	0.022***	0.015*	-0.007	0.034***	0.049***	0.088***	-0.341***

**Table 4** reports the results of advisory directors’ influence on the level of corporate risk-taking. The first column shows results of full sample test. The adjusted R-squared of the model is 0.621, illustrating that the model is a good fit. Consistent with H1, Adv\_dire is positively associated with corporate risk-taking ( $p < 0.01$ ), indicating that every unit increase in the percentage of advisory directors raises the risk-taking by 22.372 units. With more advisory directors in the board, there will be more relevant information for advisory directors to help CEOs carry out risk evaluation and investment selection. CEOs would like to pick risky but value-enhancing projects. As a result, the level of corporate risk-taking will increase.

The second and third columns show the results of non-state-owned enterprises and state-owned enterprises regression respectively. It is clear that in non-state-owned enterprises, the positive correlation between advisory directors is significant ( $p < 0.01$ ) while the state-owned enterprises subsample does not show any significance, which is a strong evidence for H2. Every unit increase in advisory directors raises the risk-taking by 41.583 units in the non-state-owned enterprises. The advisory directors don’t work since major decision-making in state-owned enterprises in China are far more complicated than those in non-state-owned enterprises.

### 4.2. Advisory Directors and the Economic Consequences of Corporate Risk-Taking

To test H3 and H4, the paper uses the following model:

$$ROA_{i,t} = c + \alpha_1 Risk\_taking_{i,t-1} + \alpha_2 Adv\_dire_{i,t-1} + \alpha_3 Risk\_taking_{i,t-1} * Adv\_dire_{i,t-1} + \sum \beta_i Control_{i,t-1} + \varepsilon_{i,t}. \tag{2}$$

Control<sub>*i,t*</sub> refers to control variables, including Firm\_size, Growth, Lev and Age. It begins with the test of full sample, and then conducts another test using the subsamples and model (2).



**Table 4.** Empirical results of advisory directors and risk-taking.

	Full sample	Non-state-owned enterprises	State-owned enterprises
Adv_dire	22.372*** (2.77)	41.583*** (2.73)	0.423 (0.22)
Firm_size	2.960*** (3.00)	9.066*** (4.58)	0.168 (0.72)
Growth	-2.887* (-1.73)	-2.898 (-0.97)	-0.471 (-1.10)
Lev	59.214*** (112.26)	60.002*** (82.72)	-0.133 (-0.14)
Age	-14.481*** (-5.00)	-21.505*** (-4.33)	1.139 (1.34)
First	-0.172** (-2.28)	-0.335** (-2.32)	0.006 (0.33)
Dual	-7.704*** (-2.75)	-9.613** (-2.08)	0.569 (0.63)
Board_size	-16.721*** (-2.65)	-40.164*** (-3.13)	-1.848 (-1.28)
Indep	-48.193** (-2.09)	-83.069* (-1.81)	-3.398 (-0.63)
Constant	-2.884 (-0.11)	-60.106 (-1.07)	6.49 (1.03)
Year and Industries	YES	YES	YES
Adj.R <sup>2</sup>	0.621	0.631	0.194
Observations	8362	4363	3829

Note: Figures in parenthesis are t-statistics values. \*\*\*, \*\* and \* denote the significance at the level of 1%, 5% and 10%, respectively.

**Table 5** reports the results of the effect of risk-taking on firm performance with the support of advisory directors. The first column shows results of full sample test. The adjusted R-squared of the model is 0.886, illustrating that the model is a good fit. Consistent with H3, the cross terms Adv\_dire\*Risk-taking is positively associated with ROA ( $p < 0.01$ ), indicating that the advisory directors and risk-taking are complementary to the improvement of firm performance. With the support of advisory directors, not only the level of corporate risk-taking is raised to high level, but it also leads the company to better performance.

**Table 5.** Empirical results of advisory directors, risk-taking and firm performance.

	Full sample	Non-state-owned enterprises	State-owned enterprises
Adv_dire	0.021 (0.91)	0.03 (0.68)	0.001 (0.12)
Risk-taking	0.004*** (7.12)	0.005*** (3.80)	0 (-0.29)
Adv_dire*Risk-taking	0.011*** (14.22)	0.012*** (7.63)	0.001 (0.09)
Firm_size	0.001 (0.23)	-0.004 (-0.60)	0.003*** (3.32)
Growth	0.008 (1.50)	0.007 (0.67)	0.007*** (3.39)
Lev	0.009*** (3.61)	0.011*** (3.13)	-0.027*** (-6.00)
Age	-0.016 (-1.66)	-0.007 (-0.42)	-0.008** (-2.06)
Constant	0.059 (0.79)	0.138 (0.91)	-0.031 (-1.14)
Year	YES	YES	YES
Industries	YES	YES	YES
Adj. R2	0.886	0.892	0.156
Observations	8362	4363	3829

Note: Figures in parenthesis are t-statistics values. \*\*\*, \*\* and \* denote the significance at the level of 1%, 5% and 10%, respectively.

The second and third columns show the results of non-state-owned enterprises and state-owned enterprises regression respectively. The cross terms Adv\_dire\*Risk-taking is positively associated with ROA ( $p < 0.01$ ) in column 2 while cross terms have no association with ROA in column 3. The result is consistent to H4 as advisory directors in state-owned enterprises help little to the decision-making.

## 5. Conclusion

This paper aims to examine the relationship between board advising and risk-taking, including the effect of board advising on the level of risk-taking and the effect of board advising on economic consequence of risk-taking. First, it is found that the increase of percentage of advisory directors in board raises the level of risk-taking. Second, the interaction of advisory directors and risk-taking contributes to the improvement of firm

performance. However, these effects are not significant at all in the state-owned enterprises due to the complicated government's interference. Compared with the non-state-owned enterprises, the positive correlation between advisory directors and risk-taking is stronger in non-state-owned enterprises. Compared with the non-state-owned enterprises, the positive association between firm performance and the interaction of advisory directors and risk-taking is stronger in non-state-owned enterprises.

Though the capital market in China has sustained rapid growth for the past few years, it is still an emerging market and is in a transitional stage of development. Meanwhile, firms in such market are faced with complex and volatile external environment, including the political environment and economic environment, which increases the difficulty of risk decision-making. Adding advisory directors to the board contributes to making decisions that are in line with the interest of the firm. Furthermore, it benefits the company by maintaining the vitality of innovation and achieving sustainable development capacity in the long run.

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