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Moderating Effects of Corporate Governance System on the Relationship between Internationalization and Performance in Chinese Corporations

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Abstract

This study uses a sample of 237 Chinese corporations to analyze the relationships between internationalization and performance as well as moderating effect that corporate governance systems have between these. The findings indicate that the internationalization of Chinese corporations do not have a positive linear relationship with the performance of them. On the other hand, the outsider ratio of the board composition and the number of audit committee members were found to moderatepositively the internationalization-performance relationship. This study provides an important practical implication for corporations that are in the process of international diversification. An effective governance system is required to achieve the positive goals of international diversification in terms of performance. If corporations cannot effectively monitor and control the decisions of top managers during international diversification, they might have significant difficulty to get positive results from such internationalization.

Keywords: Chinese Corporation, Corporate Governance System, Internationalization, Performance

1. Introduction

The effects of firms' internationalization on their performance are the well-known research question in international management[1]. Although previous studies have indicated that internationalization is important due to its linkage with performance, these often suffer from a notable sampling bias. As is well-known, researches that explore the effects of internationalization of firms on their performance are usually conducted with samples of corporations that are exclusively from developed countries[2]. It doesn't set a limitation for the value of prior researches, but the arguments made based on the findings of those researches might be limited applying to the corporations of emerging markets. This question, therefore, merits greater exploration since corporate systems of firms in emerging markets frequently do not similar with them of corporations in developed economies. Therefore, this study seeks to offer the findings of empirical analyses of the interna tionalization-performance relationships of corporations from emerging markets, specifically Chinese corporations. Recently, many Chinese corporations are seeking to operate in international markets. Internationalization enables Chinese corporations to make the best use of their competencies in global markets. It also allows Chinese corporations to obtain other advantages of internationalization including the effects of economies of scale and scope as well as learning. But, internationalization is not an easy way for growth to many Chinese corporations, and even well-known Chinese corporations have significant difficulty to successfully expand their business into overseas market. Thus, it is not clear internationalization of Chinese corporations was beneficial for their performance. Thus in this study we will answer following question: Is there any significant impacts of internationalization on the performance of Chinese corporations?

Prior studies have also represented that the corporate governance system might moderate the

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effect of internationalization on the performance of corporations. Internationalization is well-known growth strategy. It often represents a great impact on firm performance[3]. However, as with product diversification, corporations that are internationalizing might have difficulties to increase the effects of economies of scale and to reduce governance costs when they process their resources and capabilities to overseas market. Such plans might also induce the basic problems of the agency relationships that are planned and implemented by top managers to increase their personal benefits[4]. Therefore, corporations can use governance systems to monitor the decision-making of top managers during internationalization and to control their opportunistic behavior during such plans. The potential interrelationship between the corporate governance system and internationalization might be manifested as the interaction effects between them significantly influence the performance of corporations[5]. Therefore, it is important to investigate the interaction effects of internationalization with governance systems on the performance of corporations in emerging economies. Accordingly, the other objective of this study is to answer this question: How does the corporate governance system alter the effects of internationalization on the performance of Chinese corporations?

This study uses the multiyear data of Chinese corporations from 2011 to 2013. To answer the research questions, it first explores the relationship between internationalization and performance of Chinese corporations, and then, the manner in which corporate governance systems moderates this relationship is further investigated. The findings of this study are expected to contribute for further development of international management literature by using an emerging market sample and incorporating variables related to corporate governance systems in its analyses of the relationship between internationalization of Chinese corporations and performance.

2. Literature Review

2.1 Internalization and Performance

Internationalization is defined as the amount of a corporation's sales revenue that are earned from overseas market[6]. This phenomenon has been extensively studied by the researchers in international management, organization theory, and strategic management. Especially, several studies have focused on examining the effect of internationalization on the performance of corporations[7]. In general, early studies represented a positive relationship between the degree of internationalization and firm performance. Ref.[8] represents that internationalization had a significant positive effects of the internationalization of German corporations on their performance. Ref.[4] provided the same evidence as Ref.[8] by analyzing a sample of U.S. multinational corporations. However, some prior studies have also suggested no significant effects of the internationalization on firm performance. Even some others have suggested negative relationships between them. For example, Ref.[9] provided the finding that international expansion of Japanese corporations has negatively influenced to their performance.

In fact, internationalization gives various types of benefits and also costs to multinational corporations[10], and the complicated interaction of those benefits and costs entangles the internationalization-performance relationship[11]. Internationalization allows corporations to move their businesses to new markets. Firms can enhance the level of their performance by improving sales of their product and/or service in overseas markets. They can also reduce the risk stemmed from uncertainty in their home market and the costs by improving manufacturing efficiency. They can also lower costs through economies of scope in procurement, research & developmnet, promotion, distribution systems, etc. When a multinational corporation enters overseas market, it uses its resources and capabilities to overcome liability of foreignness and market imperfections[12]. In sum, we can assume that internationalization can be an effective growth strategy that is beneficial to improve overall performance of corporations[13].

Although there are lots of benefits of internationalization as suggested previously, researchers have also suggested various types of costs related to internationalization. Ref.[14] was one the first study that highlights the liabilities of multinational corporations in foreign markets. The author stated that multinational corporations would face higher costs in foreign markets because of the lack of ability to adopt local culture and governmental policies of the host country, the unique characteristics of local customers, and idiosyncratic distirbution channels. International operations also require more time and effort of managers to cooridnate and monitor firms' oprations in various markets. They also induce additional costs due to changes in products and services that are required to adjust to customers' needs of overseas markets[15]. Consequently, the benefits of internationalization should not be overestimated. They should be weighed against the various types of those costs in internationalization procedure. For this reason, the findings suggested by this line of research fail to reach the final conclusion[16]. Therefore, the effects of internationalization on the performance of multinational corporations should be further explored. In particular, underlying relationship of internationalization with the performance of emerging-market corporations needs to be researched in more detail[17].

2.2 Agency Theory and Corporate Governance System

In 1960s and early 1970s, the relationships between the management (agent) and owner (principal) of modern corporations was investigated by many researchers[18]. They define this relationship between the principal and agent as agency relationship and the problem occurred from this relationship as agency problem[19]. Agency theorists assumes that the conflict between owners and managers can arise because the interest of managers can be significantly different with that of owner[20]. They also assume that principal and the agent are motivated by self-interest. Those assumption doom agency theory to inherent conflicts that are inevitable. If both parties are motivated by self-interest, agents are likely to pursue less-risked, self-interested objectives that deviate and even conflict with the goals of principal[21].

Agency theory explains how publicly-held modern corporations can exist in spite of their separation of management with ownership[22]. Most large, publicly-held modern corporations separate the decision making functions with risk bearing[23]. Top managers is mainly responsible for making and implementing the decisions related to firms' operations while equity shareholders or residual claimants bear the risk occurred from the decisions. Because top managers do not bear a great portion of the risk that can occurred from their decisions, agency problem between top managers and shareholders can be occurred. Thus, agency theory suggests the drawbacks of managerial actions based on their self-interest. Those actions can decrease the returns of shareholder in the publicly-held modern corporation[24].

In the relationship between shareholders and managers, a corporate governance system works for shareholders. It is considered as the mechanism to protect the best interest of shareholders from the self-interest of managers[25]. Governance describes how to make the work of managers to align with the best interest of shareholders. It is beneficial to assure the maximum returns to shareholders[26]. In theory, an efficient corporate governance system improves operating performance, such as higher stock prices and higher firm valuations[27]. To this end, shareholders invest their capital to build up various types of governance systems. They believe governance systems are beneficial to align top managers' interests with their own interests[28]. Corporate governance systems are classified into two different types, internal systems and external systems. Internal systems include the board of directors, top managers' compensation systems including stock options, and ownership concentration such as institutional investors. External systems include market buy-outs that are typically activated when internal systems do not play a vital role as the corporate governance system of corporations.

2.3 Corporate Governance System of Chinese Corporations

Since the economic reforms in 1980s, the Chinese government has continuously liberalized its economic system. Accordingly, corporate governance systems of Chinese corporations have been significantly changed. Before there forms made initially in 1978, the economy system in China was centrally planned. Thus, most Chinese corporations were fully owned by government or states. However, it has been rapidly changed during the past three decades. Small government- or state-owned corporations issued their shares to the public to change ownership structure. The reforms implemented by Chinese government further expanded to big corporations. Thus, now many Chinese corporations are owned by private capital. And this change in ownership of Chinese corporations has made critically change in the corporate governance systems of Chinese corporations. Many Chinese corporations have established governance mechanisms including governance policies and board of directors[29].

The government adopted policies that encouraged greater autonomy for companies, and it tried to grant more decision-making power to management teams of corporations in addition to the overall package of economic reforms. Profit retention and sharing schemes were also introduced[30]. Furthermore, the Corporate Law of 1994 endowed the boards with ten specific functions. Important decision-making for corporate management, such as the compensation of top management team and corporate mergers and acquisitions, were finally made by boards of directors[31].

In recent years, the overall governance systems in China have displayed some convergence towards Western standards, but they have generally retained a set of distinct practices. Four distinctive features of Chinese corporate governance systems are particularly notable. First, the ownership of Chinese corporations is still highly concentrated on small number of parties despite the economic reforms. On the other hand, company ownership is generally diffuse in Western economies, with relatively few shareholders controlling more than a few percent of the shares of any given firm. Second, in spite of the continuous process of the privatization of state-owned corporations, many government institutes have still maintained a high level of ownership and thus have a strong power to influence the strategic decision of the publicly held corporations. Third, many listed corporations in China are owned and thus influenced by other listed corporation, and in turn, many of the listed corporations control other listed corporations. This type of ownership structure allows corporation extracts various resources from other corporations in its pyramid although minority owners disagree with those decisions. Fourth, because more than 70% of a typical shares of corporation were often held by the government and state, and also were not tradable before 2005, the market for corporate control actually has not been exist. When untraded shared formally moves to the open market in 2007, actual competition for corporate control became more feasible. Yet even then, large block shares of corporation–often more than half–are still in the hands of public agencies. Unlike private investors, state or government agencies are usually concerned more factors not just than maximizing shareholder value[29].

3. Methodology and Results

The research questions of this study were answered by exploring a multiyear sample of Chinese corporations. Specifically, top 100 corporations for internationalization selected by the China Enterprise Confederation and Chinese Entrepreneur Association were adopted as the sample of this study. The information for the degree of international diversification was collected by searching an annual index of internationalization for Chinese corporations from 2010 to 2012. For corporate governance systems, we measured the ratio of outside board members, the separation of the board chair with the CEO, and the number of audit committee members. All of the information for the corporate governance systerms of sample firms was, obtained from CSMR and the iFinD database. As a common gauge for organizational profitability, the return on assets (ROA) is most appropirate to assess the performance implications of governance systems. Thus, in this study, we measure the return on assets (ROA) for firm performance.

The descriptive statistics and the Pearson's correlation matrix are represented in Table 1. A review of correlations indicates no significant relationship between the degree of internationalization (DOI) and ROA. The examination of Variance Inflation Factors (VIFs) of variables was implemented to check the possible problem of multicollinearity in regression analysis. VIFs for all variables were well below the unacceptable level of 10.

A multiple regression model was examined to answer the research questions of this study. We include the firm age, industry type, firm type, and firm size as control variables. The firm age was measured as the number of years since the firm was founded. The type of industry and type of firm were measured using a dummy variable. Finally the firm size was measured as the number of employees. The results of the regression analysis are represented in Table 2.

Table 1. Descriptive Statistics and Correlations

Variables	Mean	S.D.	1	2	3	4	5	6	7	8
1. ROA 0.03 0.03										
2. Firm Size7.120.55–.221**										
3. Type of Industry0.730.45.221**–.210**										
4. Type of Firm 0.880.33–.212** .255**–.114										
5. Firm Age 25.4723.05–.058 –.118.202** .012										
6. DOI 0.130.15.018–.203**.002 –.096.038										
7. Board Outsiders Ratio 0.39 0.09 –.007.149*.018 .115 –.102–.079										
8. Separate CEO/Board 0.92 0.27-.188**.158*– .007.174**.043 –.149* –.083										
9. No. ofAudit Committee 4.24 1.43-.041.212**–.166*.163*– .068.041–.100** .116										

*<.05 ; **<.01, N=237

Table 2. Results of Multiple Regression Analysis

Variable	Model 1	Model 2	Model 3
Firm Size	−.16 (-2.38)*	−16 (-2.41)*	−.22 (-3.19)**
Type of Industry	.19 (3.02)**	.19 (2.99)**	.19 (3.02)**
Type of Firm	−.15 (-2.32)*	−.15 (-2.33)*	−.16 (-2.50)*
Firm Age	−.11 (-1.80)	−.11 (-1.78)	−.13 (-2.06)
DOI		−.03 (-0.39)	.09 (1.14)
DOI*Outsider			.15 (1.91)*
DOI*Duality			.01 (0.12)
DOI*Audit committee			.19 (2.31)*
R^2	0.115	0.116	0.157
F-statistic	7.564***	6.059***	5.300***
ΔR^2		0.001	0.041
Change in F		0.150	3.684**

*p< .05; ** p < .01.
Standardized regression coefficients are reported.
T-test results are in parentheses.

The results indicate that the DOI of Chinese corporations does not significantly influence their performance directly. However, some corporate governance systems modify the effects of the DOI on the performance of Chinese corporations. In particular, they indicate that the outsider ratio in the board composition and the number of audit committee members positively moderate the effects of internationalization on the performance of Chinese corporations. However, the separation of the board chair with the CEO does not reveal significant effects on the internationalization-performance relationship of Chinese corporations.

4. Conclusions

In this study we explore the effects of the internationalization on performance of Chinese corporations. We also examine the moderating effects of various internal governance systems on this relation. The findings offer an improved understanding on the relationship between the degree of internationalization and the performance of Chinese corporations in that the international diversification of Chinese corporations does not have a significant, direct relation to their performance. However, the performance of Chinese corporations benefits if it is planned and implemented in a corporation that has effective corporate governance systems. This study provides guidelines for corporations undertaking international diversification in practice. Effective governance systems are required to obtain the positive impacts of international diversification on performance. If the corporations are notable to effectively monitor and control the decision of top managers during international diversification, they might not be able to obtain positive net gains from internationalization. This study provide benefit to global strategy literature by using an emerging market sample and incorporating variables related to the corporate management system while testing for international diversification.

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