THE INTERNATIONAL JOURNAL OF BUSINESS & MANAGEMENT

# Corporate Governance and Risk Taking: Evidence from Italian Listed Companies

**Marina Carabelli**
Student, Department of Economic Science,
Università Cattolica del Sacro Cuore, Piacenza, Italy

***Abstract:***
*This study uses a regression model and data related to board of directors' characteristics to investigate the association between corporate governance and firms' risk levels. Building on the agency theory, we analyze 108 Italian listed companies to explore the interaction between board size and directors' attendance at board meetings and corporate risk taking. Results show that larger boards contribute to lowering firms' risk. We also find that, as board members attendance at board meeting increases, risk faced by firms decreases. Our study contributes to the extant literature as it provides evidence of the role of outside and inside directors in mitigating managers' risky practices.*

***Keywords:*** *Corporate governance, risk, board of directors*

## 1. Introduction

After the global financial crisis, authors have started to increasingly focus on firms' risk and on its determinants (Tao & Hutchinson, 2012).

Representing a fundamental factor that influences companies' performance (Mork et al., 1988; McConnel&Servaes, 1990; Gompers et al., 2003; Bebchuck et al., 2009), corporate governance practices have been thus studied in order to clarify their association with firms' risk levels (Ferrero-Ferrero et al., 2012).

According to the agency theory, shareholders and managers pursue divergent goals as, while investors aim at maximizing the value of shares (Jensen &Meckling, 1976; Shleifer&Vishny, 1997), managers are driven by different objectives, related to pecuniary ad non-pecuniary factors (Wright et al., 1996).

To this extent, shareholders must align managers' interests with their own, through appropriate incentives and appointing board directors, intended to scrutinize mangers' actions.

Hence, the board of directors represents a vital element of corporate governance (Tao & Hutchinson, 2012), as its monitoring and advising functions largely depend on its composition (Mathew et al., 2020).

In this perspective, previous studies on the relationship between corporate governance and firms' risk-taking explore the board of directors' characteristics, investigating features such as its size, the number of outside and independent directors, the number of meetings (Hutchinson 2001; Alam& Shah, 2013; Eling and Marek, 2018).

Despite theoretical predictions identifying specific traits of both the board of directors and its members that should negatively relate to risk levels, research findings are mixed and not conclusive.

Our paper aims at contributing to the extant literature by analyzing the association between corporate governance and risk in Italy. Our results show consistency with the agency theory assertions, as we find that the larger the board of directors and the higher the attendance at the board meetings, the lower the risk faced by firms.

Our work adds to previous studies as it helps to clarify how corporate governance mechanisms affect corporate risk taking, thus highlighting those features that mitigate risk levels.

The remainder of the paper is structured as follows. Section 2 presents the related literature and develops our hypothesis. Section 3 describes our sample and the research design. Section 4 presents our results. Section 5 concludes.

## 2. Literature Review

According to the agency theory predictions, based on the need for shareholders to rely on the board of directors to align managers' actions with their own interests (Jensen &Meckling, 1976; Shleifer&Vishny, 1997), most of the extant literature investigating the association between firms' risk and corporate governance focuses on the board of directors' composition and characteristics(Boubakri, 2011;Adams& Jiang, 2016; Calomiris& Carlson, 2016).

In this regard, previous studies take into account different board of directors' traits, based on the assumption of arelationship with levels of risk faced by firms.Focusing on the internal structure of corporate governance, Mathew et al. (2020) identify four different factors affecting the board of directors: board composition, related to the board size and to the percentage of outside and female directors; board leadership structure concerning factors such as CEO duality and executive ownership; board member characteristics, such as age and tenure; board processes, related to board meetings attendance and the frequency of audit committees' meetings.

The association between risk and the aforementioned factors has been largely investigated by previous research, leading to mixed evidence (Di Pietra et al., 2008; Ozdemir et al., 2021).

For example, Ferrero-Ferrero et al. (2012) find that during growth periods large board of directors negatively affect corporate risk taking, while levels of board compensation are positively related to firms' risk.In addition, no significant relationship arises with independent directors. Similar results are reported by Alam and Shah (2013) and by Deutsch et al. (2010). Differently, Hutchinson (2001) report that high percentages of inside directors lessen firms' risk taking, as well as Eling and Marek (2018). Furthermore, Tao and Hutchinson (2013)find a negative association between risk and experienced risk committees.

Inconsistent results can be explained considering that corporate governance mechanisms aim at reducing managers' discretion and to put pressure on them so align their interests with the ones of investors (Jiang & Chen, 2021). Therefore, our assumption is that their effect on corporate risk taking largely depends on shareholders' preferencesand on the degree of their portfolio diversification (Anderson et al., 2001). Thesein turn may be influenced by different factors, both at the country and firm level.

Specifically, as the majority of Italian companies are family-owned and as national investor protection is low, we maintain that, according to Shleifer and Vishny (1997),majority shareholders have the ability to monitor and exert control on insiders, thus decreasing the influence exerted by outside and independent directors. At the same time, some authors find that, when no shareholder has the absolute majority, blockholders do not remain passive but actually exert monitoring functions, also influencing the board of directors' composition and activity,specifically concerning the CEO turnover (Denis et al., 1997; Brunello et al., 2002).

We therefore suggest that, given lower monitoring power of outside directors when ownership concentration prevails, the size of the board of directors might reflect the supervising function of outside blockholders. Thus, a higher percentage of board's meeting attendance could result in greater control over insiders.

In this perspective our hypothesis is:

- H1: In Italy, corporate risk taking is negatively associated with board of directors' size and with board of directors' meeting attendance.

### 3. Sample Selection and Research Design

Startingto 350 Italian listed companies, we then excluded those operating in the financial sector and those having corporate governance missing data. Hence, our final sample consists of 108 Italian listed companies.

Corporate governance data were hand-collected from Italian listed companies' corporate governance report, while financial statements data were collected from the database Aida.

We use data related to 2018, as 2019 and 2020 financial reports are potentially affected by global pandemic of Coronavirus disease.

We test our hypothesis running a multivariate linear regression model, as specified below:

$BETA = \beta_1 BoDSIZE + \beta_2 ATT + \beta_3 LNASS + \varepsilon$

Building upon previous studies, we use Beta levered as our independent variable, measuring sampled firms' risk level.

As we suggest that larger boards of directors and higher percentages of board's meeting attendance lessen corporate risk taking, our dependent variable are the size of board of directors (BoDSIZE) and the degree of meetings attendance (ATT). We measure the board size as the sampled firms' number of both inside and outside directors appointed by shareholders. We hypothesize that this variable is negatively related to Beta levered, thus we expect $\beta_1$ to be negative and statistically significant. Board attendance is measured as a percentage, expressing the average number of board meetings attended by inside and outside directors during the financial year. Again we expect $\beta_2$ to be negatively and statistically associated to Beta levered.

Furthermore, we use firms' size as the control variable, measured as the natural logarithm of assets (LNASS)

### 4. Results

The average size of the board of directors of Italian listed companies is approximately ten members, ranging from 3 to 18. Furthermore, the variable standard deviation shows that the majority of the sampled companies has appointed from 7 to 11 directors (both inside and outside).

Focusing on the board's meeting attendance, on average directors attend at the 92.6% of the annual meetings, while the median shows that less than 50% of the sample directors attend less than 100% of the meetings.

Table 1 shows the results of the regression model.

| BETA | | | |
|---|---|---|---|
| | **Estimation** | **Std Error** | **p-value** |
| BoDSIZE. | -0.030 | 0.013 | 0.023 |
| ATT | -0.012 | 0.006 | 0.037 |
| LNASS | 0.070 | 0.021 | 0.001 |
| (Constant) | 1.219 | 0.544 | 0.027 |
| $R^2$ | 0.128 | | |
| Adjusted $R^2$ | 0.100 | | |
| Durbin-Watson | 2.043 | | |

*Table 1: Regression Model Results*

The results support our research hypothesis. Concerning the board size, we find that it is negatively (-0.030) and significantly associated to Beta levered, consistently with previous findings. This confirms that, for Italian listed companies, larger boards of directors mitigate corporate risk taking.

In addition, firms' risk levels appear to be negatively (-0.012) and significantly influenced also by directors' attendance at board meetings, consistently with theoretical predictions. Thus, directors actively participating in board of directors' activities contribute to lower risk-taking practices.

Conversely, we find a positive (0.070) and significant relationship between risk levels and company size, thus suggesting that the larger the company, the higher the risks faced.

## 5. Conclusions

The global financial crisis, raising concerns on risk and on firms' risk taking, has called the attention on the role of corporate governance practices as a means to prevent excessive risk taking.

The extant literature has thus investigated corporate governance mechanisms that contribute to lessening risk levels, focusing on the board of directors and on its characteristics, according to previous theoretical predictions.

As no conclusive evidence exists on the topic, our study contributes to previous literature by analyzing the association between board of directors' features and firms' risk levels, in a poor shareholders' protection and concentrated ownership context.

Our findings show consistency with theoretical assumptions, confirming the monitoring function of the board of directors. In this regard, we report a mitigating role played by directors on corporate risk taking, as results show that large boards and active directors' participation contribute to lessen risks faced by firms.

This study suffers from some limitations that future research could address. First, we do not include in our analysis variables related to board composition and characteristics (Mathew et al., 2020) such as the number of independent or female directors and tenure. Secondly, we focus on just one financial year, while observations covering longer periods could help to clarify the topic. Lastly, we suggest that national peculiarities could have mediating effects on the association between corporate governance and risk.

## 6. References


i. Adams, M., & Wei, J. (2016). Do Outside Directors Influence the Financial Performance of Risk-Trading Firms? Evidence from the United Kingdom (UK) Insurance Industry.*Journal of Banking and Finance* 64, 36–51. http://dx.doi.org/10.1016/j.jbankfin.2015.11.018.

ii. Alam, A., & Ali Shah, S. Z. (2013). Corporate governance and its impact on firm risk. *International Journal of Management, Economics and Social Sciences*, *2*(2), 76-98. http://dx.doi.org/10.2139/ssrn.2280479

iii. Anderson, R. C., Mansi, S. A., & Reeb, D. M. (2003). Founding Family Ownership and the Agency Cost of Debt.*Journal of Financial Economics* 68(2), 263–85. https://doi.org/10.1016/S0304-405X(03)00067-9

iv. Bebchuk, L., Cohen, A., & Ferrell, A. (2009). What matters in corporate governance? *The Review of financial studies*, *22*(2), 783-827. https://doi.org/10.1093/rfs/hhn099

v. Boubakri, N., Dionne, G., & Triki, T. (2008). Consolidation and value creation in the insurance industry: The role of governance. *Journal of Banking & Finance*, *32*(1), 56-68. https://doi.org/10.1016/j.jbankfin.2007.09.004

vi. Brunello, G., Graziano, C., & Parigi, B. M. (2003). CEO turnover in insider-dominated boards: The Italian case. *Journal of Banking & Finance*, *27*(6), 1027-1051. https://doi.org/10.1016/S0378-4266(02)00244-3

vii. Calomiris, C. W., & Carlson, M. (2016). Corporate governance and risk management at unprotected banks: National banks in the 1890s. *Journal of Financial Economics*, *119*(3), 512-532. https://doi.org/10.1016/j.jfineco.2016.01.025

viii. Denis, D. J., Denis, D. K., & Sarin, A. (1997). Ownership structure and top executive turnover. *Journal of financial economics*, *45*(2), 193-221. https://doi.org/10.1016/S0304-405X(97)00016-0

ix. Di Pietra, R., Grambovas, C. A., Raonic, I., & Riccaboni, A. (2008). The effects of board size and 'busy'directors on the market value of Italian companies. *Journal of management & governance*, *12*(1), 73-91. https://doi.org/10.1007/s10997-008-9044-y

x. Eling, M., and Marek,S. D. (2014). Corporate Governance and Risk Taking: Evidence from the U.K. and German Insurance Markets.*Journal of Risk and Insurance* 81(3): 653–82. https://doi.org/10.1111/j.1539-6975.2012.01510.x

xi. Ferrero-Ferrero, I., Fernández-Izquierdo, M. Á., & Muñoz-Torres, M. J. (2012). The impact of the board of directors' characteristics on corporate performance and risk-taking before and during the global financial crisis. *Review of Managerial Science*, *6*(3), 207-226. https://doi.org/10.1007/s11846-012-0085-x

xii. Gompers, P., Ishii, J., & Metrick, A. (2003). Corporate governance and equity prices. *The quarterly journal of economics*, *118*(1), 107-156. https://doi.org/10.1162/00335530360535162

xiii. Hutchinson, M. (2001, November). Firm risk, corporate governance and firm performance. In *Governance and corporate social responsibility in the new millennium: Governance and Social Responsibility Conference: proceedings of the 2001 Conference, 26th & 27th November 2001* (pp. 1-16). School of Accounting and Finance, Deakin University.

xiv. Jensen, M. C., & Meckling, W. H. (1976). Theory of the firm: Managerial behavior, agency costs and ownership structure. *Journal of financial economics*, *3*(4), 305-360. https://doi.org/10.1016/0304-405X(76)90026-X

xv. Jiang, J., & Chen, Y. (2021). How does labor protection influence corporate risk-taking? Evidence from China. *Pacific-Basin Finance Journal* 68(20): 101572. https://doi.org/10.1016/j.pacfin.2021.101572.

xvi. Mathew, S., Ibrahim, S., & Archbold, S. (2020). Corporate governance and firm risk. *Corporate Governance: The international journal of business in society*. 18(1), 52-67 https://doi.org/10.1108/CG-02-2017-0024

xvii. McConnell, J. J., & Servaes, H. (1990). Additional evidence on equity ownership and corporate value. *Journal of Financial economics*, *27*(2), 595-612. https://doi.org/10.1016/0304-405X(90)90069-C

xviii. Morck, R., Shleifer, A., & Vishny, R. W. (1988). Management ownership and market valuation: An empirical analysis. *Journal of financial economics*, *20*, 293-315. https://doi.org/10.1016/0304-405X(88)90048-7

xix. Ozdemir, O., Erkmen, E., & Binesh, F. (2021). Board diversity and firm risk-taking in the tourism sector: Moderating effects of board independence, CEO duality, and free cash flows. *Tourism Economics*, 13548166211014367, 1–23. https://doi.org/10.1177/13548166211014367

xx. Shleifer, A., & Vishny, R. W. (1997). A Survey of Corporate Governance.*Corporate Governance and Corporate Finance: A European Perspective,52*(2): 52–90. https://doi.org/10.1111/j.1540-6261.1997.tb04820.x

xxi. Tao, N. B., & Hutchinson, M. (2013). Corporate governance and risk management: The role of risk management and compensation committees. *Journal of Contemporary Accounting & Economics*, *9*(1), 83-99. https://doi.org/10.1016/j.jcae.2013.03.003

xxii. Wright, P., Ferris, S. P., Sarin, A., & Awasthi, V. (1996). Impact of corporate insider, blockholder, and institutional equity ownership on firm risk taking. *Academy of Management journal*, *39*(2), 441-458. https://doi.org/10.5465/256787