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The Role of Independent Directors in Corporate Governance and Their Impact on Over-Investment

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Abstract:

This article systematically reviews the role and challenges of independent directors in curbing overinvestment in enterprises. Based on the agency theory framework, this article analyzes the theoretical path for independent directors to improve investment efficiency through supervision, consultation, and signal transmission mechanisms. Research has found that although independent directors theoretically have governance effectiveness, their actual effectiveness is significantly constrained by practical difficulties such as lack of independence, information barriers, and insufficient incentives. This article further reveals the situational dependence of independent director effectiveness and points out that its effectiveness is deeply influenced by institutional environment and equity structure. Finally, The research findings of this paper show that this article proposes policy recommendations for shifting from formal compliance to substantive effectiveness, including optimizing the selection mechanism and improving the incentive compatibility system. This study provides important insights into the effectiveness of corporate governance mechanisms and has reference value for governance practices in emerging markets.

Keywords: Independent directors; corporate governance; overinvestment; agency theory; board effectiveness.

1. Introduction

The integrity of corporate governance is widely regarded as one of the most important determinants of the long-term success of a firm. Costs arise from the agency problems of managers and shareholders [1]. If these are left to unabated, they will result in inefficient investment behavior and the consequent misallocation of company resources. And one of the most damaging consequences of such misallocation of resources is overinvestment [2]. And if considering the international financialization realities, the success of the making of corporate investment decision may be one of the most important determinants of firm performance and market stability today. Investment efficiency, that is, neither under- nor over-investment is the main problem of finance of corporate now. Therefore in order to address the above issues, many jurisdictions have evolved so called independent directors' (IDs) regimes. The aim is that their introduction will result in an increase in board mediation, an improvement in transparency to investors through an increase in the quality of decision-making, and in investment behavior that is much closer to shareholder-value maximization [3].

The independent director system was introduced into Chinese publicly traded companies in the early 2000s. And it was mimicked from governance structures in established markets such as the United States and the United Kingdom [4]. The rationale was to reduce the power of controlling shareholders and managers so that corporate choices would reflect the long-term interests of all investors. According to China Securities Regulatory Commission (CSRC), publicly traded companies should ensure that at least one-third of their board consists of independent directors [5]. And they should play an unbiased supervisory role, reduce the self-servicing behavior of managers and improve the quality of decisions. Particularly with regard to investment behavior, independent directors should take an active part in assessing, analyzing and overseeing investment endeavors so as to avoid inefficient allocation of company resources and reduce the common phenomenon of overinvestment.

Furthermore, the empirical evidences reveal a different and more complex picture than the one painted by theory. Although independent directors are generally thought to be representatives of shareholder interests, their effectiveness in preventing overinvestment seems to be very much dependent on their personal abilities. For instance, the empirical analysis has strong evidence that independent directors who are able to perform audits are much more effective in preventing overinvestment by Chinese listed companies [6]. They exist to provide essential scrutiny of the company's financial statements and the investment plans of managers, thereby protecting investors from irresponsible risk-taking. Similarly, "scientist independent directors (people with scientific research accomplishments)" have a more striking restraining effect on over-investment [7]. Particularly in the high-tech field, when the scientist ID's hold board committee positions and are not heavily burdened or politically appointed.

In addition, many findings underscore that it is not just whether independent directors exist, but which type and in what institutional environment they operate that matters. Indeed, practice reveals persistent dilemmas. Some independent directors in China are criticized as mere "ornamental" or "rubber stamp" figures, lacking real power or access to relevant information. And others are stretched thin by serving on multiple boards or lack appropriate incentives. Moreover, cultural and institutional factors in China, such as relational culture, informal pressure, and weak enforcement of accountability, often diminish their capacity to act independently. Consequently, a more profound question arises: is the independent director inherently ineffective, or is its effectiveness significantly reliant on institutional characteristics and implementation circumstances? The 2023 changes (CSRC Measures) indicate regulatory acknowledgment of these contingencies: elucidating rights, responsibilities, and liabilities, and enhancing support for information accessibility and professional qualifications [5].

Therefore, this article presents a systematic review of the role of independent directors in mitigating over-investment, focusing on the theoretical institutional functions (monitoring, information intermediary, risk control) and the practical challenges observed in China and similar emerging-market contexts. Therefore, this essay will mainly focus on answering two research questions, which are respectively. First, through which mechanisms can IDs curb over-investment? Second, under what boundary conditions (board power dispersion, ownership, director attributes) do these effects strengthen or weaken (China focus)? Also, the principal contributions are: (1) synthesizing significant literatures to reflect the most recent empirical research and regulatory developments especially in China; (2) elucidating the transmission mechanisms through which the attributes of independent directors (expertise, audit/training background, workload, political connections) affect over-investment; (3) deriving lessons and policy implications for enhancing the system to enable independent directors to more effectively fulfill their governance responsibilities.

2. Literature Review

2.1 Overview of Literature Themes

This review of the literature is structured around two core areas. First, it examines the theoretical functions of independent directors as a corporate governance mechanism, drawing on their roles of monitoring, information intermediary, and risk control. Second, it explores how over-investment happens and its relation to IDs. By understanding these two distinct but interconnected bodies of research, this section establishes the theoretical basis for why independent directors are expected to mitigate excessive investment.

2.2 Conceptual Foundations: Agency Theory and Over-investment

The overinvestment indicates that managers who attempt

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to establish enterprises or obtain personal benefits with inadequate supervision and an abundance of internal cash ultimately allocate an excessive amount of capital to projects that fail to generate revenue (Negative Net Present Value). This is formalized through the free-cash-flow hypothesis, while broader agency theory illustrates how misaligned incentives distort investment when boards are unable to effectively challenge management. These issues are exacerbated in China by concentrated ownership and weakened protections for investors, which underscores the necessity of credible board-level checks and balances. This explains why it is believed that independent directors (IDs) result in more efficient investments.

2.3 Institutional Role of Independent Director

Independent directors have long been regarded as a panacea to good corporate governance. Only independent directors, being independent from making decisions, would have the ability to act in an objective manner and not be conflicted of interest. According to the Organisation for Economic Co-operation and Development , independent directors are defined by three criteria which excludes former employees and immediate family of executive and substantial company equity holders [8]. The China Securities Regulatory Commission defines an independent director in the Chinese market as someone who has no relationship with the listed company such that it would affect their ability to make objective judgments in making decisions [5]. The direct effect of independence of directors is to enhance oversight objectivity and to increase decision transparency and protect against self-serving managerial actions.

According to classical theory of governance, there are three functions of independent directors. First, as the mechanism of independent directors exerts on, the independent director monitors the executive and avoids the self-serving managerial opportunistic behaviors especially in the company which ownership and control are separated [3]. This view emphasizes that directors protect shareholders interests by preventing self-serving behaviors of managerial actions. Second, the independent director acts as the information intermediary, that is, corporate insiders are connected to the outside people, for example, the independent director increases disclosure and reduces the information asymmetry [9]. Through this, the director improves the board of directors decision-making process by providing outside information arguing for more disclosures. Thirdly, the independent director plays the role of risk management by arguing against the aggressive strategies, for example, arguing for more board level decision making [10]. This reflects that the independent director plays a role in instilling a sense of prudence, especially when the company faces an ambiguous investment environment or formidable strategic challenges.

These three functions may be well established, but they only may work under certain conditions. Based on the study of dissenting behavior in board meetings, the recent study concludes that in China, independent directors say little when confronting with political-affiliated Chief Executive Officer (CEO) or concentrated ownership [11]. This denies the monitoring role and risk control to some extent. A similar highly cited study just concludes that, only the independent directors who have received substantial training in related aspects of governance from auditors tend to perform substantially in restraining excessive investment 7 and others who are less trained financially had little effect.

Some of this insights have been taken into recent reforms. In 2023, the CSRC Measures put forward strengthened requirements for an individual to qualify as an independent director, limited the number of overlapping directorships and gave clearer guidance regarding the rights and duties of associated directors [5]. Such measures try to improve the boards independence and effectiveness; however, many researchers claim that unless accompanied by more fundamental changes in culture and incentives, legal reforms may have only been marginally effective [12]. While the institutional role of independent directors is conceptually robust, their performance in China appears mixed and dependent on director background, board design and institutional environment.

2.4 Over-investment and Its Relation to Independent Director

Over investment is still a persistent and complicated problem. It isn't generated from one factor, but results from the combination of other factors such as the managerial incentive misalignment and agency conflict and so on. Furthermore, the problem which is common in developing countries like China is added on. That is, structural factors (Politically-connected own ship, cultural preference) cause the problem even more exacerbated. In this section, it discuss the explanation of above problem and the relationship between independent directors through theory analysis and empirical study.

Indeed, having more money than needed is also a problem existing in corporation; and the cost has been extremely high in the past. Over-investment: which means the behavior that corporation invested more resources into the project that reduce value of businesses instead of creating new value, had become a habit in corporate finance. And the previous sentence's definition of above behavior is described by free cash flow hypothesis [2]. In addition, the research that put forward the behavior that the manager with more internal money owned by them would definitely set up the project that fulfilled their personal purposes such as empire building, or promoted their career advancement even though the above projects would bring low returns or even negative [3]. However, the paper also discussed agency theory concept while recorded how the shareholder - manager with different incentive cause the misaligned decision [13]. For example, expansion purposes of management team would be retionalized by overstating income projections or vague strategic goals when the board was passive or controlled by insiders. And above purposes were retionalized by outsiders to impose any restriction hard especially in the less well enforced countries like China own ship was very concentrated and the protection of investors was bad.

Although the theoretical basis of over investment, but the empirical study needs the practical definition to find and analyze the over investment that happened in other firms and context. To ground the discussion in a measurable way, over investment is usually assessed by two standard methods in the literature of corporate finance. The first method models the expected amount of investment based on fundamental characteristics such as sales growth, size of the firm, and leverage. And most of current studies used those actual numbers, interpreted the positive residuals as the abnormal or inefficient investment [14]. This residual based investment efficiency measure is widely used in the empirical studies of governance and investment behavior.

Further, certain additional empirical research in China confirms the severity of this issue. A study conducted a quasi-natural experiment demonstrating that independent directors improved investment efficiency, particularly in firms with lower state ownership and more dynamic board committees [14]. In other words, those companies with politically linked management or inadequate disclosure processes will reduce the positive impact of independent directors. Moreover, the cultural emphasis on harmony and hierarchy within Chinese corporations may further inhibit criticism. As a previous study noted, in the condition of the presence of influential or politically connected CEOs, the independent directors often refrained from voicing dissent during meetings, even when they acknowledged issues [15]. These findings support the notion that cultural context is significant and single formal positions alone do not ensure effective monitoring.

To sum up, the causes contributing to over-investment are complicated, which include factors like executive intent, cash flow availability, board dynamics, and cultural influences. Independent directors theoretically offer a mechanism to limit excessive investment; however, their effectiveness is contingent upon a network of interconnected variables.

2.5 Summary of Theoretical Insights

The extant scholarship converges on a contingent rather than universal assessment of independent directors' (IDs) capacity to mitigate overinvestment. Conceptually, IDs operate through three interlocking channels—enhanced monitoring, improvements in information quality, and risk-attuned deliberation. Empirically, however, the magnitude and even the direction of these effects depend on identifiable boundary conditions. Effectiveness rises when directors possess relevant financial or audit expertise, face manageable workloads, and work within boards that diffuse chief-executive power, empower committees, and tolerate dissent. Conversely, CEO duality and dominance, state-ownership incentives, cultural aversion to confrontation, and director busyness attenuate scrutiny and render "independence" largely nominal. Recent regulatory refinements in China plausibly elevate the ceiling for functional independence, yet implementation and board-process bandwidth remain decisive. Accordingly, the debate should shift from whether IDs work to when and through which mechanisms they do so. The subsequent sections formalize these contingencies into testable propositions and derive policy and managerial levers to translate formal independence into measurable investment discipline.

3. Positive Influence of Independent Directors on Over-investment

3.1 Overview of Mechanisms

This section explores the mechanisms through which independent directors can benefit the corporation also help reduce overinvestment. Building on the theoretical foundations discussed earlier, it focuses on three interrelated governance functions: monitoring managerial behaviour, enhancing information transparency, and raising board-level sensitivity to risk. These functions represent individual pathways through which independent directors can influence capital allocation choices. Below are subsections elaborating on their operational practice and surveying relevant empirical evidence, with a special reference to China.

3.2 Monitoring Mechanism: Limiting Agency Problems

One of the main ways independent directors are expected to reduce over-investment is by improving how the board monitors management and limits agency problems. One major role of monitoring of independent directors is viewed as reducing the likelihood of opportunistic behaviour by management or dominant shareholders in a principal agent setting [16]. As mentioned in the literature review, the agency theory posits that managers do not always prioritize the interests of shareholders, particularly when they have significant internal capital under their control. In such instances, they may be inclined to provide financial support for initiatives that enhance their per-

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sonal reputation or influence, regardless of their financial viability. Further, when the roles of decision-making and risk-bearing are separated in modern corporations, this kind of external oversight becomes particularly important [3]. However, the mechanism of independent directors is more likely to intervene and challenge potentially detrimental decisions because they are typically recruited from outside the company and are not closely associated with the CEO. Some empirical studies provide support for this viewpoint. For instance, the study demonstrates that IDs contribute to the enhancement of investment efficiency in Chinese listed companies, particularly when they are significant board committees and the authority of the CEO is not excessively concentrated [15]. Similarly, another study asserts that U.S. firms with surplus free cash flow are less inclined to engage in excessive investment when their boards comprise a higher number of independent directors [17]. Therefore, these results indicate that the independent director mechanism exists as a monitoring role that can be beneficial in optimizing capital utilization when they are implemented under the appropriate circumstances.

3.3 Information Role: Improving Transparency and Investment Quality

In addition to the monitoring role in managers, the independence directors reduce overinvestment by improving the information transparency. Academically, they are called as information intermediaries who reduce the information asymmetry between company insiders and outsiders [9]. Particularly, when the managers exaggerate the benefits of projects or even cover up the bad news, it is more important to improve the information quality of the messages communicated between company insiders and outside stakeholders. And independence directors can force the board to more carefully evaluate investment proposals by improving the information quality of the messages communicated between company insiders and outside stakeholders. Particularly, since the independent director is in a more favorable position to request more detailed explanations or make more challenging questions because he is not the member of managerial group. It ensures that the board has a better understanding of the situation before making decisions to invest a large amount of money [9]. Even though, it also burdens executives to provide credible data to support their executive proposals. The information role becomes even more important in some special countries, such as China, where investor protection is limited and company transparency is still lacking [12]. Therefore, improving information transparency, especially in such a developing country, is very important to improve corporate efficiency and inhibit risky investment.

The information role of independent directors is also supported by empirical facts. For instance, the study found that the firms are more likely to reject low-quality investment proposals when the independence directors participate more actively in audit or strategy committees . The reliability of capital allocation decisions are improved by the advocacy of directors for more realistic earnings projections and more thorough due diligence. Thus, since the independent directors are a bridge between managers and outside investors, they can reduce the information gap. Therefore, when the managers know that their plans will be questioned and even reported externally, they will not exaggerate the returns or even cover up the potential risks.

3.4 Risk Oversight: Raising Board-Level Risk Sensitivity

In addition to oversight and transparency, independent directors are essential in mitigating over-investment by enhancing the firm's overall risk awareness. Independent directors aid in risk management by providing external viewpoints and specialized knowledge, which assists the company in identifying excessively ambitious investment opportunities. As proved by the study, who suggest that boards with more engaged and well-informed members are better at challenging management when necessary [10]. Thus, an informed independent director with their own professional consideration becomes useful when firms are considering ambitious spending plans that might carry hidden risks. In addition, this theoretical view is supported by empirical findings that observe that independent directors with professional auditing backgrounds are more effective in curbing excessive corporate spending [6]. For example, directors with financial, legal, or auditing experience are often better equipped to read through technical documents, ask critical questions, or even spot red flags before approving a major project.

Nevertheless, as highlighted in the literature review, the effectiveness of this risk-control mechanism is not certainly guaranteed. Research observes that these advantageous outcomes may be constrained when the board culture inhibits discourse or when directors hesitate to confront dominant CEOs [11]. Although independent directors can mitigate overinvestment by promoting transparency and risk awareness, their actual impact is contingent upon the functionality of the board and the willingness of the firm to implement changes. In the long term, addressing structural issues such as CEO duality and insufficient autonomy for directors may be equally crucial as recruiting professionals with the right expertise. Because of in the absence of comprehensive reforms, even the most competent independent directors may only serve a symbolic role and fail to prevent over-investment.

To sum up, independent directors contribute to a reduction in over-investment by incorporating external perspectives and institutional knowledge that counterbalance over-confidence. Furthermore, the additional value derived from independent directors becomes more pronounced when they possess experience in areas such as auditing or finance, as these experiences help them to be more adept at recognizing overly aspirational, long-horizon and risky projects. Nevertheless, the presence or absence of board culture and power dynamics plays a major role in whether the independent directors are effective. If board culture and power dynamics are not supportive, it may be difficult for even the most qualified independent directors to have an impact on decisions made by other directors on the board.

3.5 Summary of Mechanism-Based Insights

Overall, independent directors may find an important role in assisting companies in avoiding over-investment. They augment the capacity of boards by acting a monitoring role and enhancing the transparency of the firm to spot perilous or overly ambitious projects earlier. Also, when directors come with a certain expertise, such as in auditing or finance. Their backgrounds are often better suited for questioning assumptions and taking a safer stance in key decisions.

However, the extent of their actual influence is also subject to the environment, which does not mean effectiveness. In the event that the board is not sufficiently supportive with regard to fostering debate or that the CEO is domineering, the independent director mechanism might be less efficient. Therefore, this recognition naturally leads to the next section, which sets out the boundary conditions in more details.

4. Boundary Conditions and Moderating Factors

4.1 Overview of Contextual Constraints

The literature and the preceding mechanism analysis jointly indicate that the effectiveness of independent directors in restraining over-investment is conditional, rather than universal. Even though the mechanism of independent directors stimulates the efficiency of the corporation by various aspects. However, there are still a series of conditions that pivot on a set of interlocking boundary conditions. This section discusses key boundary conditions that constrain how independent directorship operates in reality. These include the internal distribution of power within boards, the wider political and ownership structure of firms, and institutional norms that affect how symbolic or engaged these directors truly are. This section synthesizes those conditions to clarify when independent directorship travels from a nominal designation to a working governance device in China.

4.2 CEO Power and Board Dynamics

This form of power concentration refers to the concentration of decision-making authority within a controlling chief executive. In other words, under instances of CEO duality or long tenure, thus diminishes the ability of independent directors to dissent from decisions [18]. The traditional form of separation-of-powers logic presumes that those who bear risk can effectively constrain those who make decisions [3]. However, this mechanism of regulation weakens once executive power supersedes board authority. Further evidence from China portrays the infrequent instances of overt dissent in situations of absolutely dominant CEOs, which instead proves the value of space and expertise for substantive expression [11]. Therefore, the process is influenced by structural forces, since the aforementioned channels of Section 3 will be constrained from functioning effectively without the distribution of power.

4.3 Ownership, State Influence, and Political Economy

In a country like China, which is defined as a “Socialism with Chinese characteristics”, State ownership and concentrated control complicate incentives and dampen the marginal contribution of independence [19]. Under firms featuring a single predominant controlling shareholder and those featuring state ownership, there commonly exists an alignment of non-commercial goals and relational forces with profitability goals. Here, independent directors can be more resistant to challenging projects, given that policy priorities or informal expectations become more important than Net Present Value (NPV) at the project level. Independent directors, on the other hand, tend to exert more influence over screening and allocation of capital in privately owned firms or firms featuring more dispersed ownership, explaining why their questions and criticism become more important. Existing work from China additionally argues that independent directors are more efficacious under conditions of weaker state influence and under active board committees, thus participating in better investment choices [15].

4.4 Institutional Constraints and Symbolic Appointments

Beyond structural condition challenges, a deeper issue lies in how independent directors are institutionally positioned within many firms. In some cases, they are appointed more to satisfy regulatory requirements than to genuinely participate in strategic oversight [20]. The tokenistic use of independent directors (IDs) undermines the essence of board independence. While companies may appear to

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comply with governance norms on paper, the practical involvement of these directors in decision-making processes is often minimal. This issue is compounded by the growing trend of "overboarding," where a single director sits on multiple boards at once. As highlighted by past research, directors who are overstretched across too many firms are significantly less likely to be engaged in any one of them, thereby weakening their ability to meaningfully challenge questionable investment decisions [21]. Practically, this subsection suggests that concrete diagnostic indicators are necessary: the number of outside directorships, the attendance at meetings, the time to materials, and the dissent/revision rates at the committee level. If these indicators indicate low bandwidth or symbolic roles, "independence" is nominal and unlikely to prevent over-investment; however, independence becomes functional when bandwidth and mandate are credible.

4.5 Summary of Boundary Effects

Table 1. Independent directors, mechanisms, and moderators

Mechanism	Expected Effect	Key Moderators (±)	Empirical Evidence (China)
Monitoring	Over-investment	(–) CEO duality / overconfidence (+) CEO-board separation	Chen, Ke & Yang (2021); Ma & Khanna (2016)
Information Intermediation	Over-investment	(+) Audit committee role (+) Board transparency (–) Political connections	Chen et al. (2021); Tang (2017)
Risk Oversight	Over-investment	(+) Audit or science expertise (–) Tokenism / director busyness	Li, Li & Weng (2025); He et al. (2025); Xu et al. (2022)

Note: indicates reduction in over-investment.
(+) means the moderator strengthens the Independent Director.
(–) means the moderator weakens the effect of Independent Director.
In conclusion, these findings are synthesized in Table 1, which outlines the channels through which independent directors operate, the boundary conditions that moderate their effectiveness, and supporting evidence from China. While independent directors are theoretically equipped to restrain over-investment. However, their practical effectiveness is heavily shaped by a range of constraints. As discussed in this section, factors like concentrated ownership, symbolic appointments, excessive board responsibilities, and cultural norms are considered. These boundary conditions help explain the disconnection between formal governance structures and the substantive oversight role directors are expected to perform. As a result, it is essential to surpass conventional notions of independence but investigate the specific organizational contexts in which directors operate. The following section utilizes these findings to consolidate the principal conclusions of this study and examines prospective policy initiatives and future research opportunities

5. Conclusion

This essay has examined how independent directors influence corporate over-investment, with a focus on the Chinese context. While existing theory presents a clear case for their governance value, including monitoring, information, and risk oversight. However, the practical effectiveness of independent directors is conditional. For example, cultural norms, board power dynamics, and symbolic nominations often constrain their ability to intervene. The existence of independent directors does not inherently lead to improved investment performance.
The study concludes that the effectiveness of the directors depends on a number of interconnected factors. The factors are the effectiveness of the expertise of the directors, the extent of their information accessibility, the level of power centralization of the CEO, and if the directors are stretched thin due to their service on many board roles. Without alleviation of these limitations, even the best-qualified independent directors cannot adequately address inefficient investments. Nevertheless, the role of a governance structure for an independent director remains central, if there exist structure and institutionally converged conditions.
Improving the effectiveness of independent directors requires reforms on several fronts. First, the appointment process should stress the need for directors with relevant professional experience. For instance, relevant expertise in auditing, finance, or scientific fields as previously mentioned. Earlier findings had shown that such Directors had a better ability to reduce over-investment. Furthermore, there have been some regulatory changes introduced recently by the CSRC, which have tried to increase the level of sophistication; however, inconsistencies across practice persist.
In addition, independent directors would be required to participate in critical board committees and maintain ac-

curate information during this process. The capacity of independent directors to act is diminished by restrictive board structures that restrict participation or defer disclosure.

Another challenge lies in "overboarding". When directors hold excessive external positions, their engagement naturally declines. Companies limiting unnecessary appointments and tracking attendance should thus be able to refocus attention. Finally, incentive structure reform might refocus attention on long-term value by tying compensation to long-term performance, not temporary income, or profits for that matter. This might make wiser investments more likely and make boards more disciplinary.

For the future, there are at least two other future directions for research that could be considered. One direction would consist of investigating the contribution of independent directors in the ESG and sustainability-related decision-making processes. Another direction would consist of cross-country comparisons in order to obtain a more comprehensive picture of the impacts of institutional setting on the governance contribution of independent directors.

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