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Leadership Structure and Value Relevance During Corporate Governance Reform

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ABSTRACT

The sample of this study consists of Main Board companies listed on Bursa Malaysia from 1999 to 2001. This study investigates the effect of the issuance of the Malaysian Code on Corporate Governance (MCCG) on value relevance of accounting number. The main objective of this paper is to examine the effect of leadership structure on the value relevance of equity book value and earnings following the corporate governance reform by employing the Ohlson (1995) Valuation Model and based on the methodology developed by Davis-Friday et al. (2006). The findings generally indicate that equity book value and earnings are value relevant in assisting investors to value firms' equity. Mixed results for leadership structure were found where the value relevance of equity book value increase whilst the value relevance of earnings decrease when companies practice duality structure in 2000. It, therefore, implies that the role of CEO and Chairman of the board should be separated in order to improve the value relevance of earnings. In summary, the findings of this study provide evidence that the equity book value and earnings reported in the financial statement is value relevant in valuing Malaysian firms' equity. More importantly, the recommendation by the MCCG to practice unitary leadership

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structure is deemed vital in improving the value relevance of earnings in Malaysia and hence must be implemented fully.

Keywords: *Corporate governance, leadership structure, book value, earnings, value relevance*

Introduction

Earlier study found that higher standards of governance were experienced following the implementation of the Cadbury Code of Best Practices (Thompson, 2003; MCCG). Hence, in an attempt to raise the standards of corporate governance, Malaysian Code on Corporate Governance (MCCG) was introduced in March 2000 by the Finance Committee of Corporate Governance (FCCG), setting out the principles and best practices on structure and process that companies may use in their operations to attain optimal governance framework. Subsequently, Capital Market Master Plan (CMP) and Financial Sector Market Plan (FSMP) were launched to complement the issuance of the Code. Bursa Malaysia Berhad even revamped its Listing Requirements to ensure that listed companies comply with MCCG. Thus, this underscores the importance of the Code as the main source of corporate governance reform in Malaysia.

MCCG stresses on the role of board of directors to establish good corporate governance for they are responsible to monitor the performance of the manager so that the interest of the shareholder is protected. As financial reporting is employed to narrow the undesirable influences of information asymmetries, the emphasis is thus on the usefulness of the information rather than on the accountability or stewardship of management in reporting to shareholders. As such, responsibility of the board embraces providing reasonable assurance that the financial information conveyed is useful for decision making purposes i.e. value relevance.

The Code further suggests that there should be a clearly accepted division of responsibilities at the leadership structure in order to ensure a balance of power and authority i.e. separation between the position of board Chairman and CEO. The rationale for the separation of role is to avoid one individual having unfettered powers of decision. This, thus, raise concern on whether the leadership structure as recommended by the Code improves the value relevance of equity book value and earnings.

Motivated by the lack of study on the value relevance in the area of corporate governance in Malaysia (Adibah, Nor'Azam and Asyaari, 2009), this paper extends the analysis of Davis-Friday et al. (2006) to investigate the effectiveness of governance mechanism proposed by the country in influencing the quality of the financial reporting. Specifically, this study investigates the effects of leadership structure on the valuation of equity book value and earnings following the governance reform. Thus, this paper addresses the scarcity of value relevance research in the light of corporate governance. This is essential given the differences in institutional structures between Malaysia and other developed countries such as US and UK that might have bearing on corporate governance.

Literature Review and Hypothesis Development

Coles et al. (2001) divided the leadership structure of a company into combined leadership structure and separate structure, thereby distinguishing between CEO duality, where a single person is the CEO as well as the chairman of the board; and unitary structure where the position of CEO and chairman were held by different persons. This is of high concern because CEO is claimed to be the single most powerful individual in an organization, meanwhile, the board's chairman is the person who can exert significant control over the board of directors through his power to set the board's agenda (Mintzberg, 1983).

MCCG suggests a separation of the leadership role in order to balance the power of authority to allow for proper control on decision. There are two conflicting views in relation to this issue. It has been argued that when the CEO is also the chairman of the board, the board intensity to monitor and oversee the management is reduced due to lack of independence and a conflict of interest (e.g. Fizel and Louie, 1991; Dobryzynski, 1991; Millstein, 1992). This argument is based on agency theory, which claims that chairman has to be independent in order to check on the possibility of the over-ambitious plans of the CEO. The reason is that when someone holds two top positions, they tend to pursue strategies for their own benefit at the expense of the company as a whole (Jensen and Meckling, 1976; Jensen, 1986).

Conversely, stewardship theory supports the combined leadership structure or CEO duality based on the arguments that directors are viewed as guardians of corporate assets and wishing to do their best for the company (Haniffa and Cooke, 2002) and as such enhance their effectiveness. CEO duality is also advocated to allow the CEO to shape the company to attain desired objectives for there will be less interference (Eisenhardt, 1989). According to Dahya et al. (1996) minimum board interference allows CEO with strategic vision to shape the future direction of the company, hence, leading to a better performance. Further, Stewart (1991) demonstrates that role duality enhance decision-making process for it permits sharper focus on company's objectives and promotes more rapid implementation of operational decisions. Consequently, they tend to report information that better reflect the economic condition of the company, i.e. high quality of reporting.

The company's CEO is inevitably the single most powerful individual in an organization meanwhile the board's chairman is the person who can exert significant control over the board of directors through his power to set the board's agenda (Mintzberg, 1983). Forker (1992) contended that the separation of the CEO and chairman position will help to enhance monitoring quality and reduce the advantages of withholding information, thereby improving the quality of reporting. In addition, CEO duality is associated with poor corporate disclosure, supporting the view that the position of chairman and CEO should be separated (Gul and Leong, 2004).

In this regard, MCCG proposed for the separation of the two roles in order to have a sound governance system. Accordingly, it is hypothesized that the separation of board Chairman and CEO role following the recommendation made by the Code will have positive effect on the value relevance of book value and earnings.

H1: The value relevance of equity book value and earnings increases when there is a separation of role between CEO and board Chairman following the corporate governance reform.

Research Methodology

Theoretical Model

This study is an extension to the analysis made by Davis-Friday et al. (2006); where the market value of equity is regressed on book value of equity and earnings per share, i.e. based on the Ohlson's (1995) Valuation Model. Consistent with Davis-Friday's (2006), the models in this study will also have an indicator variable to measure the effect of governance reform. The following model was then developed, consistent with Model 3 of Davis-Friday et al. (2006) to examine the effect of leadership structure on the extent of changes in the value relevance of equity book value and earnings following the Malaysian governance reform.

$$\begin{aligned} \mathrm{MVS}_{it} = {} & \beta_0 + \beta_1 I + \beta_2 J + \beta_3 \mathrm{BVS}_{it} + \beta_4 I^*\mathrm{BVS}_{it} + \\ & \beta_5 J^*\mathrm{BVS}_{it} + \beta_6 \mathrm{LS}^*I^*\mathrm{BVS}_{it} + \beta_7 \mathrm{LS}^*J^*\mathrm{BVS}_{it} + \\ & \beta_8 \mathrm{EPS}_{it} + \beta_9 I^*\mathrm{EPS}_{it} + \beta_{10} J^*\mathrm{EPS}_{it} + \\ & \beta_{11} \mathrm{LS}^*I^*\mathrm{EPS}_{it} + \beta_{12} \mathrm{LS}^*J^*\mathrm{EPS}_{it} + \varepsilon_{it} \end{aligned} \tag{1.1}$$

where MVS_{it} is the market value of equity per share of company *i* at year *t*; *I* is an indicator variable equal to 1 if 2000 (the year of issuance of MCCG) and 0 if otherwise; *J* is an indicator variable equal to 1 if 2001 (the year MCCG took effect) and 0 if otherwise; BVS_{it} is book value per share of company *i* at year *t*; and EPS_{it} is earnings per share of company *i* at year *t*; LS is an indicator variable taking on the value of 1 for CEO duality and 0 if otherwise.

The independent variables comprise of book value, earnings and leadership structure. Book value refers to equity book value per share of company (BVS) measured by the common shareholders' fund per-unit of shares. Meanwhile earnings refer to earnings per share of company (EPS) measured by earnings before extraordinary items per-unit of shares. The reason earnings before extraordinary items were used rather than using net income or earnings is to avoid any non-recurring items in the earnings component which will mislead the valuation of share prices. This is based on the argument by Collins et al. (1997) who contend that investors perceive non-recurring items as transitory in nature, therefore, affecting the permanent component of earnings. As a result, it will impair the value relevance of earnings.

Meanwhile, leadership structure (LS) is measured by binary variable in which 1 is assigned if CEO is also the chairman of the board and 0 if otherwise (consistent with Forker, 1992; Gul and Leong, 2004; Shamsul Nahar, 2004; Chang, 2004; Rashidah and Roszaini, 2005). Consistent with Davis-Friday et al. (2006), this study will use market value of equity per share of company (MPS) as the dependent variable measured by the company's share price as at the end of the financial year-end.

Sample Selection and Data Collection

The introduction of the Malaysian Code on Corporate Governance in March 2000 was indeed among the initial steps taken to raise the standards of corporate governance following the deterioration of investors' confidence on the credibility of the Malaysian capital market as a result of the financial crisis in 1997. Therefore, consistent with Rashidah and Roszaini (2005), the sample period of 1999 to 2001 was selected to examine the value relevance of book value and earnings prior and following the period governance reforms took place in Malaysia. In addition, the year 2001 was the year when part of the recommendation for best practices contained in the Code forms part of the Bursa Malaysia Listing Requirements.

The sample in this study consists of companies listed on the Main Board of Bursa Malaysia from 1999 to 2001. In order to be included in the sample, all companies listed on the Main Board of Bursa Malaysia were selected except for financial (e.g. banks and insurance) and unit trusts companies. The reason for excluding the financial and unit trust companies is due to differences in the regulatory requirements in their reporting which might cause differences in the valuation parameters from those in other industrial firms, hence this might create bias in the end result (Graham and King, 2000).

Accounting data, specifically earnings, book value and market value for the sample was then collected from Thomson Financial DataStream. In order to obtain clean data for observation, all the missing data were deleted. Further, consistent with Graham and King (2000), those observations with negative book values were removed from the sample for these companies are likely to be in financial distress, and as such might result in different association between the equity book value and earnings and market value. Those with non-availability of data were omitted from the sample. Similar to Collins et al. (1997), observations which fall in the top and bottom one-half percent for each variable were deleted in order to control the effects of extreme values. Annual reports for the sample of companies were then downloaded from Bursa Malaysia's website and Thomson OneBanker Database and were analyzed to gather information in relation to leadership structure. This resulted in a final sample of 560 observations for the period under study i.e. 158 companies in the year 1999, 188 companies in the year 2000 and 214 companies in the year 2001.

Findings and Discussions

Descriptive Statistic Results

Table 1 tabulates the mean, standard deviation, minimum and maximum values of the continuous variables and the frequency of the dichotomous variables. On average, both the share price and equity book value are found to be declining over the period, i.e. from RM2.40 to RM1.70 for the former and from RM2.35 to RM2.28 for the latter. Meanwhile the accounting earnings declined from RM0.21 to RM0.14 in 2000 but jumped to RM0.99 in 2001.

Table 1: Descriptive Statistics for All Variables (N = 560; 1999-2001)

Continuous Variables	N	Mean	Standard deviation	Minimum	Maximum
1999					
MVS	158	2.3966	1.9804	0.4100	10.9000
BVS	158	2.3518	1.2210	0.1585	5.9747
EPS	158	0.2091	0.3389	-1.0991	1.0976
2000					
MVS	188	2.1332	2.0273	0.2300	11.3000
BVS	188	2.3134	1.3542	0.1720	7.6442
EPS	188	0.1381	0.2398	-0.5229	0.8721
2001					
MVS	214	1.6847	1.4751	0.2000	9.7000
BVS	214	2.2757	1.2980	0.2044	7.7798
EPS	214	0.9891	0.2926	-1.0865	1.1663
Dichotomous variables		Year	N	Yes (%)	No (%)
LS (CEO duality)		1999	158	20.9	79.1
LS (CEO duality)		2000	188	17.0	83.0
LS (CEO duality)		2001	214	17.3	82.7

Note: BVS_{it} is book value per share of company i at year t; and EPS_{it} is earnings per share of company i at year t; LS is an indicator variable taking on the value of 1 for CEO duality and 0 if otherwise.

Table 2 tabulates the correlation analysis for the variables. The findings indicate that equity book value and accounting earnings are positively and significantly correlated with share prices. Further, both equity book value and earnings are positively and significantly correlated at a moderate association. This finding is consistent throughout the period of study. It, therefore, suggests that equity book value and earnings are value relevance accounting information to investors in the valuation of market value of shares before and following the period corporate governance reform took effect.

Table 2: Correlation Matrix of the Variables

Variable	MVS	BVS	EPS
1999 [N = 158]			
BVS	0.384***		
EPS	0.406***	0.613***	
LS	0.062	-0.043	-0.053*
2000 [N = 188]			
BVS	0.441***		
EPS	0.536***	0.498***	
LS	0.038	0.011	-0.013
2001 [N = 214]			
BVS	0.593***		
EPS	0.526***	0.496***	
LS	0.014	-0.096	-0.026

(***) significant at 1%; (**) significant at 5%; and (*) significant at 10% (two-tailed)

Note: BVS_{it} is book value per share of company i at year t; and EPS_{it} is earnings per share of company i at year t; LS is an indicator variable taking on the value of 1 for CEO duality and 0 if otherwise.

The Effect of Leadership Structure on the Extent of Changes in the Value Relevance of Equity Book Value and Earnings Following the Malaysian Governance Reform

Table 3 presents the effect of leadership structure on the relative value relevance of equity book value and accounting earnings following the corporate governance reform. Again, the results are consistent with the results presented in Table 1, where adverse effect on overall market value was found for post-MCCG year (β_2 = -0.680; t = -2.253). Meanwhile, the equity book value and earnings are positively and highly associated with the market price, thus, implying the value relevance of equity book value and earnings during and following the year MCCG was introduced (β_3 = 0.365; t = 2.441; β_8 = 1.309; t = 2.298). Further, it was found that the corporate governance reform had an impact on the valuation of earnings, as evidenced by the positive and significant coefficient on the interaction between the year governance reform took place and earnings per share (β_9 = 3.198; t = 3.041).

Table 3: Regression of Market Value of Equity on Equity Book Value and Accounting Earnings, Controlling for Corporate Governance Reform and Leadership Structure

$$\text{MVS}_{it} = \beta_0 + \beta_1 I + \beta_2 J + \beta_3\text{BVS}_{it} + \beta_4 I^*\text{BVS}_{it} + \beta_5 J^*\text{BVS}_{it} + \beta_6\text{LS}^*I^*\text{BVS}_{it} + \beta_7\text{LS}^*J^*\text{BVS}_{it} + \beta_8\text{EPS}_{it} + \beta_9 I^*\text{EPS}_{it} + \beta_{10} J^*\text{EPS}_{it} + \beta_{11}\text{LS}^*I^*\text{EPS}_{it} + \beta_{12}\text{LS}^*J^*\text{EPS}_{it} + e_{it} \quad (4.3)$$

	β_0	β_1	β_2	β_3	β_4	β_5	β_6
Coeff.	1.266	-0.393	-0.680	0.365	-0.093	0.034	0.350
t-stats.	4.888	-1.138	-2.253	2.441	-0.490	0.200	2.103
p-value	(0.000) ***	(0.256)	(0.025) **	(0.015) **	(0.625)	(0.841)	(0.034) **

	β_7	β_8	β_9	β_{10}	β_{11}	β_{12}
Coeff.	0.166	1.309	3.198	0.116	-6.475	-0.626
t-stats.	1.418	2.298	3.041	0.141	-4.113	-0.815
p-value	(0.157)	(0.022) **	(0.003) ***	(0.888)	(0.000) ***	(0.416)

[F-stats = 18.254 (0.000)***] [Adjusted R^2 = 0.286] [N = 560]
(***) significant at 1%; (**) significant at 5%; and (*) significant at 10%.

Note: MVS_{it} is the market value of equity per share of company i at year t; I is an indicator variable equal to 1 if 2000 (the year of issuance of MCCG) and 0 if otherwise; J is an indicator variable equal to 1 if 2001 (the year MCCG took effect) and 0 if otherwise; BVS_{it} is book value per share of company i at year t; and EPS_{it} is earnings per share of company i at year t; LS is an indicator variable taking on the value of 1 for CEO duality and 0 if otherwise.

Mixed results were found, hence, partially supporting H1. The coefficient for the interaction between year 2000 and leadership structure was found to be positive and statistically significant on book value per share (β_6 = 0.350; t = 2.103). In contrast, a negative and significant coefficient was found for earnings per share (β_{11} = -6.475; t = -4.113). The evidence indicates that when MCCG was introduced, CEO duality helps to improve the value relevance of book value per share, but reduce the value relevance of earnings. In the event companies practice duality structure, investors might view that the CEO cum board Chairman have the tendency to commit earnings management. As a result, they shift earnings to book value when valuing firms' value, hence, resulting in the increase in the value relevance of book value.

Of significance is that duality leadership structure reduce the value relevance of earnings (β_{11} = -6.475; t = -4.113), thereby suggesting that companies should separate the role of CEO and board Chairman in order to improve the value relevance of earnings. This, thus, underscores the importance of compliance with the recommendation contained in the Code. In other words, new governance mechanism proposed by MCCG, i.e. to practice unitary leadership structure, should be implemented fully as it helps to improve the value relevance of earnings.

Meanwhile, leadership structure no longer had an impact on the value relevance of either book value per share or earnings per share post-MCCG period. This may be contributed to the fact that the effect of leadership structure has had only a marginal impact on the effectiveness of the way Malaysian companies operates, which is consistent with Owen and Kirchmaier (2006) who document similar results post-Cadbury period. Further, in 2001, any risk arising from the concentration of power in one person, would be offset by the presence of a senior independent director to whom concerns should be conveyed to, as required by the Bursa Listing Requirements in 2001. Hence, it is possible that either company practice role duality or unitary structure, the presence of a senior independent role may play a more significant role post-MCCG period. However, further research needs to be done in order to justify this proposition.

Conclusion and Recommendations

This study attempts to investigate the effect of leadership structure following the corporate governance reform on the value relevance of equity book value and earnings. The introduction of MCCG in the year 2000 marked initial development of corporate governance reform in Malaysia, hence, it is expected that the value relevance of equity book value and earnings improves during and after the Code was introduced.

Overall, results indicate that leadership structure does have an impact on the value relevance of equity book value and earnings. Duality leadership structure is found to increase the value relevance of equity book value but decrease the value relevance of earnings. One plausible reason is that some investors view the duality structure as associated with earnings management, hence shift the earnings to book value when valuing the firms' value. More essentially, evidence suggests that practicing unitary structure helps to improve the value relevance of earnings. It, therefore, indicates that the recommendation contained in the Code to separate the role of CEO and board Chairman is deemed significant to improve the value relevance of earnings reported by Malaysian companies, and hence, should be implemented fully. Hence, more efforts are needed to raise the standard of corporate governance in Malaysia, to ensure that the application of the corporate governance practices helps to protect the shareholder's long term, while at the same time increase the value relevance of equity book value and earnings for equity valuation.

Future studies may want to extend the period of the study to cover longer and more recent periods. This is because, following the Listing Requirements 2001, companies are required to provide Statement of Corporate Governance in their annual report. As such, investors may view leadership structure as relevant in determining the value of the firm. Future study may examine, as only leadership structure was considered in this study, other effects of corporate governance mechanism on the value relevance of equity book value and earnings can contribute more to the literature. This includes ownership structure, board size, audit quality and etc. In addition, analysis on the effectiveness of senior independent non-executive directors may provide further evidence on the mixed findings on leadership structure presented in this study.

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