CORPORATE BOARD: ROLE, DUTIES & COMPOSITION

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Postal Address:

Postal Box 36
Sumy 40014
Ukraine

Tel: +380-542-698125
Fax: +380-542-698125
e-mail: alex_kostyuk@mail.ru
alex_kostyuk@virtusinterpress.org
www.virtusinterpress.org

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Почтовый адрес редакции:

Почтовый ящик 36
г. Сумы, 40014
Украина

Тел.: +380-542-698125
Факс: +380-542-698125
эл. почта: alex_kostyuk@mail.ru
alex_kostyuk@virtusinterpress.org
www.virtusinterpress.org

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Corporate Board: Role, Duties & Composition

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EDITORIAL

Dear readers!

This issue of the journal is devoted to several issues of corporate board practices.

Afzalur Rashid examines if the CEO duality influence the firm economic performance in Bangladesh and the moderating effects of board composition in the form of outside independent directors. While doing so, he examines the relationship between CEO duality and firm performance during the pre appointment of outside independent directors and post appointment of outside independent directors (the role of other corporate governance mechanism as moderating variable). The finding is that there is there is a negative (non-significant) relationship between CEO duality and firm performance before appointment of outside independent directors in the board. However, independent leadership structure and firm performance is found to be positively related following the acquisition of resource (outside independent directors in the board) supporting the 'resource dependence theory'. The findings of his study partially support the 'agency theory' and 'resource dependence theory' but do not support the stewardship theory. The study contributes to the literature on CEO duality in the context of less a developed country.

Muhammad Nurul Houqe and Tahmin Fatema Islam utilize two basic approaches to measure the quality of earnings which control two different dimensions of earnings management. The research design is structured primary on the basis of calculating two different measures of the quality of earnings on the industry level and on the company level. They calculate earnings quality for New Zealand public firms from the OSIRIS database for 2004-2007. This research concludes that various stakeholders should apply more than one measure for the quality of earning in order to have strong evidence about the level of quality before taking any corrective action or making any decision related to that company. If one company is having low quality of earning according to one technique and high quality of earnings according to another, the stakeholders cannot have a final conclusion about that company and they need more investigations and analysis to assess the quality of earnings.

Vincenzo Capizzi, Renato Giovannini mentioned that in the last decade the number of buyback transactions involving listed companies in the Italian equity capital market has experienced a huge growth. However, no clear understanding of this phenomenon has yet been reached, also because of the limited information available on such financial decisions. The purpose of their paper is to check the main hypotheses behind the determinants of share repurchases, analysing the effect of own share buyback announcements specifically on the performance of the listed companies before and after the discontinuity introduced in Italy through the Reform of the financial markets. The first major outcome coming from the empirical analysis deals with the strong incentive played by the reform mentioned above, which introduced stricter corporate governance criteria, leading to a sharp increase in the volume and frequency of share buyback announcements, as well as in the number of companies getting access to this instrument. The analysis also strongly supports the replacement hypothesis theory, which states that buybacks have become a better substitute for dividends as a remuneration policy for shareholders.

Ian O'Boyle stated that performance management is a process that has been used in the for-profit business environment for many years and has had significant benefit for that sector. As the not for-profit organisation enters new dimensions of competitiveness, increased professionalism and a call for greater transparency, the utility of a performance management approach within the not for-profit environment and its potential benefit for such an organisation is explored. The application and appropriateness of the balanced scorecard as a measurement tool is analyzed within his article and it becomes apparent that such a tool can have a direct impact on the performance of the modern not for-profit entity.

Shamharir Abidin, Nurwati A. Ahmad-Zaluki, Desi Ilona provide us with an analysis on the effect of board quality on company performance. Using a sample of 133 companies listed on the Jakarta Stock Exchange in the year 2007, their study specifically examines whether multiple directorships, director shareholding and board independence (i.e. proxies for board quality) can be associated with company financial performance. Their study also investigates the effect of audit committee characteristics (as proxied by audit committee independence and financial expertise) on company performance, while controlling for the effects of leverage and size. With regard to board quality, the results indicate that only board independence is found to be associated with performance, though in the opposite direction. The direction of influence suggests that having too many independent directors (i.e. non-executive) might slow down the business as they might have a lack of detailed knowledge about the company's business, and are more concerned about their gatekeeper role.

Chen Ying and Sidney Leung examine the effects of director ownership and the proportion of outside directors on firms' commitment to corporate social responsibility (CSR). Using a sample of 453 Hong Kong listed companies for 2005, they found that there is a non-linear relationship between the level of director ownership and firms' engagement in CSR behavior. Commitment to CSR first increases as the proportion of director ownership increases up to 50% and then decreases as that proportion of ownership grows higher. Further, the proportion of outside directors on the board exhibits a positive relationship with the level of CSR commitment. These results provide explanations for firms' commitment to CSR from the corporate governance perspective.

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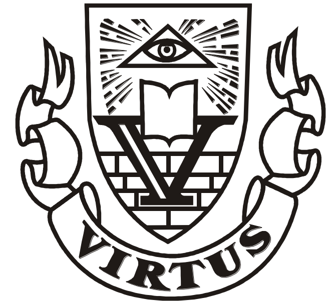

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BOARD LEADERSHIP STRUCTURE AND FIRM PERFORMANCE: AN EXAMINATION OF RESOURCE DEPENDENCE ROLE

Afzalur Rashid*

Abstract

This study examines if the CEO duality influence the firm economic performance in Bangladesh and the moderating effects of board composition in the form of outside independent directors. While doing so, it examines the relationship between CEO duality and firm performance during the pre appointment of outside independent directors and post appointment of outside independent directors (the role of other corporate governance mechanism as moderating variable). The finding is that there is there is a negative (non-significant) relationship between CEO duality and firm performance before appointment of outside independent directors in the board. However, independent leadership structure and firm performance is found to be positively related following the acquisition of resource (outside independent directors in the board) supporting the 'resource dependence theory'. The findings of this study partially support the 'agency theory' and 'resource dependence theory' but do not support the stewardship theory. This study contributes to the literature on CEO duality in the context of less a developed country.

Keywords: Agency Theory, Bangladesh, Independent Directors, CEO, Power, Resource Dependence, Stewardship Theory

**School of Accounting, Economics and Finance, University of Southern Queensland, Toowoomba, QLD 4350, Australia*
Tel: +61-7-46315515
Fax: +61-7-46315594
Email: afzalur.rashid@usq.edu.au
Web: www.usq.edu.au

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1. Introduction

Due to separation of ownership and control the fortune of modern corporations are entrusted to the professional managers. A corporate board is a primary and dominant internal corporate governance mechanism which plays a key role in monitoring management and aligning the interest of shareholders with management (Rose, 2005; Brennan, 2006). A board may give strategic guidelines to the management and even may act to review and ratify management proposal (Jonsson, 2005). Board also spot the problems early and blows the whistle (Salmon, 1993). However, there is a considerable debate in the literature to what extent a corporate board is able to monitor management (see Mizruchi, 2004, p 614; Brick *et al,* 2006, p 421; Braun and Sharma, 2007). It came to light in the wave of corporate scandals that broke out in early 2000s, such as Enron, WorldCom and HIH insurance. It is alleged that a cause of these scandals are due to insufficient monitoring as the management holds board members in a strong grip (Rose, 2005). It commonly happens when the board Chair and the CEO is the same person (CEO duality). In such a situation board is usually dominated by the management, which reduces the board's ability to exercise the governance function and creates a conflict between management and board (Morck *et al*, 1988; Zahra, 1990; Rechner and Dalton, 1991; Tricker, 1994; Yermack, 1996; Solomon, 2007). It also

gives enormous power and authority to the CEO, reduces the check and balances and weakens the board, as the CEO tends to be motivated by self-interest (Tricker, 1994). It reduces the board independence and its ability to exercise the governance role (Fizel and Louie, 1990; Pearce II and Zahra, 1991; Baliga *et al,* 1996; Dalton *et al,* 1998). Such board may be less involved in understanding their responsibilities than their powerful counterparts (Pearce II and Zahra, 1991).

The management of a corporation mostly oversees the operational issues and headed by Chief Executive Officer (CEO) who has overall responsibility for the conduct and performance of an entire organization' (Finkelstein and Hambrick, 1996, p 7). It is argued that the board will neither be involved in the day-to-day operational activities of the management nor be the part of management, as it may lead to a conflict of interest between the management and board (Morck *et al*, 1988; Rechner and Dalton, 1991; Tricker, 1994; Yermack, 1996; Abdullah, 2004). Due to legalistic perspective board is responsible for corporate leadership without actual interference in day to day operations, which are duties of CEO and senior executives (Zahra and Pearce II, 1989, p 292). The CEO will bridge between the corporate board and management (Rechner and Dalton, 1989). Leadership skill of the board Chair is an important factor in determining board process, optimal decision making and overall effectiveness of a board of directors (Leblanc, 2004; Leblanc, 2005).

In response to the large number of corporate collapses and scandals around the world, corporate governance reforms have been instigated to prevent such events happening again to protect the interest of investors. The U. K. 'Cadbury Report 1992', the first corporate governance code of best practices, was developed and published in response to the collapses of Maxwell Publishing Group, BCCI and Poly Peck (OECD, 2004b; Jonsson, 2005). The Cadbury Code made a number of recommendations for boardroom reforms including the structural independence of the board. It recommends that, "there should be clearly accepted division of responsibilities at the head of the company, which will ensure a balance of power and authority, such that no one individual has unfettered powers of decisions." Many countries also published the mandatory or voluntary corporate governance codes, for example, Higgs Report 2003 in the United Kingdom; Bouton Report 2002 in France and Cromme Commission Code 2002 in Germany (see Chahine and Tohme, 2009), Toronto Stock Exchange Listing Requirements in Canada (see Kang and Zardkoohi, 2005) suggesting the boardroom reform, in particular the structural independence of the board or splitting the role of CEO and board Chair (i. e. CEO non-duality). Sarbanes-Oxley Act in 2002 following the corporate scandals in the United States (such as Enron, WorldCom) led to a number of additional checks and balance in place to monitor the actions of the CEOs (Dey *et al,* 2009). In the words of Aguilera (2005, p 39):

> *In the post-Enron era, corporate governance reforms around the world are fully underway to bring greater power balance within the firm – particularly reining in over-mighty chief executives – and to resolve power struggles among the different stakeholders*

As part of this reform movement, in 2006 Bangladesh announced the 'Corporate Governance Notification' suggesting a major reform within the corporate boards in Bangladesh. Although it is a voluntary regulation (as non-compliance requires an explanation) it can be considered as the code of corporate governance best practices in the context of Bangladesh. It requires the listed firms in Bangladesh to have Anglo-American type outside independent directors (at least one-tenth of the total directors subject to a minimum one). However, that code compulsorily requires the structural independence (CEO non-duality) within the corporate boards in Bangladesh.

This study examines if the board leadership structure (CEO duality) influences the firm economic performance in Bangladesh during pre and post-appointment of outside independent directors (the role of outside independent directors as a moderating variable on CEO duality). The choice of Bangladesh is notable as over the past decades an overwhelming proportion of corporate governance literature has concentrated on developed economies with sophisticated financial and legal systems (Ararat and Yurtoglu, 2006) and where there are many institutional similarities. There is a dearth of research and less concentration is given on corporate governance practices in less developed and emerging economies (Gibson, 2003; Denis and McConnel, 2003; Ararat and Yurtoglu, 2006; Uddin and Choudhury, 2008). Needless to say there is a dearth of research on corporate governance practices in Bangladesh even though there is an increased interest on corporate governance practices by international donor agencies, such as Asian Development Bank (ADB), International Monetary Fund (IMF), World Bank and other international donor agencies (see Uddin and Choudhury, 2008; Siddiqui, 2010). The 'Global Corporate

Governance Forum', an IFC multi-donor trust fund facility, argues that corporate governance is a powerful tool to battle against poverty (World Bank, 2007). In the context of Bangladesh it is so warrant that the World Bank has imposed conditions requiring the improvement of corporate governance practices in Bangladesh in order to get financial assistance (Solaiman, 2006). Most of the earlier studies on CEO duality and firm performance originate from Anglo-American context. The evidence of CEO duality and performance in the context of an emerging economy may contribute to the new avenue of knowledge on strategic leadership.

The remainder of the paper is organized as follows. Section two presents the institutional background of corporate board practices in Bangladesh. Section three presents the earlier studies on CEO duality and firm performance. Section four presents the theoretical background and develops the hypotheses. Section five presents the methodological issues. Section six presents the results. The final section draws a conclusion.

2. Institutional Background of Corporate Board Practices in Bangladesh

Unlike the corporate boards in continental Europe, such as Germany, Finland and the Netherlands (except United Kingdom), the corporate boards in Bangladesh are one-tier board or management board. This is also due to common law tradition of the country[1] (as opposed to civil law). There is no supervisory board and both the executive and the non-executive directors perform duties together in one organizational layer, which is most common in Anglo-Saxon countries such as, the United States, the United Kingdom and Canada, Australia, and New Zealand. Therefore, there are some incidences of CEO duality in many listed companies, giving enormous powers to the CEOs, which may reduce the check and balances and ultimately the monitoring function of the board. The recent regulation (the 'Corporate Governance Notification') requires the board size to be between 5-20 directors, appointment of an 'Independent' or 'Non-Shareholder Directors' in the Board (at least $1/10^{th}$ of the total board members or minimum one).

The CEO non-duality, which separates the executive function of the board from its monitoring function, is commonly found in two-tier board, which is most common in continental Europe, (except United Kingdom) such as Germany, Finland and the Netherlands (Tricker, 1994; Maassen, 2002). The CEO duality is very unusual in two-tier boards as the CEO is the part of the executive board and has no seat in the supervisory board; such supervisory function of the board is formally independent from the executive (management) function. The management functions of the board mostly oversee the operational issues and headed by Chief Executive Officer (CEO) and supervisory functions of such board deals with the strategic decision and oversee the management function of the board headed by Chairperson as non-executive director (Solomon, 2007). A notable intuitional difference in Bangladesh corporate sector from that of developed economy is that, due to diffuse share ownership, firms in developed economy appoints professional managers; many of them do not have ownership stakes within the firm and they employ their undiversified human capital (managerial talent) within a single firm. However, executives in Bangladesh are the family owners; many of them have large stake of ownership control or they are the representatives of the family owners. Sobhan and Werner (2003) noted that, in about 73% of the non-bank listed companies, the boards are heavily dominated by the sponsor-shareholders who generally belong to one family-the father as the chairman and the son as the CEO. Therefore, CEOs in the context of Bangladesh do not employ their undiversified human capital within a single firm.

3. Earlier Studies on CEO duality and Firm Performance

There is a host of studies examining the CEO duality and firm performance in the context of developed market (such as, Berg and Smith, 1978; Chaganti *et al,* 1985; Davidson *et al,* 1990; Donaldson and Davis, 1991; Boyd *et al,* 1997; Rechner and Dalton, 1989; Rechner and Dalton, 1991; Pi and Timme, 1993; Daily and Dalton, 1992; Daily and Dalton, 1993; Daily and Dalton, 1994a; Daily and Dalton, 1994b; Daily and Dalton, 1994c; Daily and Dalton, 1995; Baliga *et al,* 1996; Worrell *et al,* 1997; Dalton *et al,* 1998; Fosberg, 1999; Simpson and Gleason, 1999; Coles *et al,* 2001), except some handful studies for example by Mak and Li (2001) and Wan and Ong (2005) in the context of Singapore, Judge *et al* (2003) in the context of transitional economy, such as Russia; Abdullah (2004) in the context of Malaysia; Elsayed (2007; 2009; 2010) and Kholeif (2008) in the context Egypt; Tian and Lau (2001) and Lin (2005) in the context of China, Kula (2005) in the context of Turkey and Lam and Lee (2008) in the context of Hong Kong.

Most of these studies mainly examined the CEO duality and firm performance and arrived at contradictory outcomes. Although there is a counter argument that it is management team structure which affect performance and internal monitoring devices may not be as effective as envisaged in the literature ((see for example, Pi and Timme, 1993). Many prior studies suggest that CEO duality and firm performance is contextual (see Elsayed, 2007; Rashid, 2010). Board leadership structure varies across firms, industries and countries (Elsayed, 2010). CEO duality and firm performance varies across environmental dimension (Boyd, 1995); firm size and nature of financial performance has a moderating influence on CEO duality and firm performance (Dalton *et al,* 1998); board size, the proportion of outsiders on the board, and prior firm performance is required for more understanding of the CEO duality (Worrell *et al,* 1997); CEO duality and firm performance is contingent on family ownership stake (Mak and Li, 2001; Braun and Sharma, 2007; Lam and Lee, 2008); CEO duality varies with board size, top managerial ownership and institutional ownership (Kholeif, 2008); CEO duality varies with firm size, age and ownership structure (Elsayed, 2009).

Despite a host of studies on CEO duality and firm performance, such studies in the presence of other corporate governance (moderating) variable are very sparse. In the words of Kang and Zardkoohi (2005, p 793), "the lack of clear cut relationship between CEO duality and firm performance may be attributed to the failure of existing paradigms to shed light on the moderating effects of a firm's internal and external conditions". Ramdani and van Witteloostuijn (2010) examined the CEO duality and firm performance from a sample firms from Indonesia, Malaysia, South Korea and Thailand. They found that board independence and CEO duality on firm performance is different across the conditional quantiles of the distribution of firm performance. They also found a negative moderating effect of board size on the positive relationship between CEO duality and firm performance. Elsayed (2010) adds a new dimension of research on CEO duality examining what constitutes CEO duality arguing that appropriate leadership structure varies with some contextual variables. Rashid (2010) examined if CEO duality influences firm performance in Bangladesh and noted that CEO duality and performance varies across industries. The study of CEO duality and firm performance mainly originates from Anglo-American context. The current study aims at investigating the moderating effect board composition (in the form of representation of outside independent directors) on the relationship between CEO duality and firm performance. It draws on existing theory of corporate governance by testing those in a new context. Providing data from a less familiar (less developed economy) context this study aims to contribute to the literature by recognizing the interest of academics and practitioners.

4. Theoretical Background and Hypotheses Development

In understanding the principal-agent relationship (corporate governance and its problems), a theoretical lens is required. There are two extreme theoretical underpinnings in explaining such problem and subsequent impact on firm performance. These are agency theory (such as, Alchian and Demsetz, 1972; Ross, 1973; Jensen and Meckling, 1976; Fama, 1980; Fama and Jensen, 1983, Eisenhardt, 1989); stewardship theory (such as, Donaldson, 1990a, 1990b; Davis *et al,* 1997; Donaldson and Davis, 1991).

4.1. Agency Theory

Due to effective separation of ownership and control, the power of modern corporations is delegated to the professional managers (agents) who oversee the interests of dispersed shareholders (Mintzberg, 1984). However, as the professional managers may not have significant interest in the firm in the form of stock ownership, there may be a problem of aligning the interest of the dispersed shareholders leading to an agency problem (such as Jensen and Meckling, 1976). Due to this the agent (the management) may be driven by self-interest, and unless restricted from doing otherwise, will undertake self-serving activities that could be detrimental to the economic welfare of the principal (shareholders) (Deegan, 2006, p 225). Different mechanisms, incentives, checks and balances are proposed to motivate and/or to monitor the management to align the interest of management with that of shareholders. The agency theorist suggests that agency problem will be higher when there is a CEO duality or CEO is also the board Chair (see Yermack, 1996). Separating the position of CEO and board Chair (CEO non-duality) will reduce the CEOs dominance over the board (Daily and Dalton, 1994b; Maassen, 2002) leading to a powerful board (Pearce II and Zahra, 1991). It allows the board to better exercise its control and reduces the self-opportunism' of CEO and other inside directors (Daily and Dalton, 1994a). It also facilitates the objective assessment of CEO and top management performance (Weidenbaum, 1986).

4.2. Stewardship Theory

In sharp contrast, stewardship theory holds an optimistic view of human (managerial behavior) suggesting that managers are inherently trustworthy and not prone to misappropriate corporate resource, rather they are motivated to work in the interest of their principal (Barney, 1990; Donaldson, 1990a, 1990b; Donaldson and Davis, 1991; Davis *et al,* 1997; Dalton *et al,* 1998). Therefore, this theory argues for CEO duality. This theorist suggests that the power of the executives and best stewardship role can only be exercised when the role of the CEO and board Chair is combined, (Donaldson and Davis, 1991; Ong and Lee, 2000). When CEO is rewarded with a chair position for his/her performance, the board is expressing its confidence in the CEOs ability to lead the firm (Kang and Zardkoohi, 2005).

4.3. Resource Dependence Theory

The main premise of the agency and stewardship theory is that, 'one size fits all' (Elsayed, 2010) or 'one therapy for all diseases'. Contrary to agency and stewardship view, 'resource dependence theory' suggests that the long-term survival and success of a firm is critical to its abilities to link the firm with its external resources (Pfeffer and Salancik, 1978). A corporate board is also a means for facilitating the acquisition of external resources such as, legitimacy, advice and counsel and links to other organizations, which is critical to the firm's success (Pfeffer and Salancik, 1978; Zahra and Pearce II, 1989; Gopinath *et al,* 1994; Johnson *et al,* 1996; Maassen, 2002; Hillman and Dalziel, 2003; Kula, 2005). This is because "when an organization appoints an individual to a board, it expects the individual will come to support the organization, will concern himself with its problems, will variably present it to others, and will try to aid it" (Pfeffer and Salancik, 1978, p 163). Consistent with this view academic literature (such as, Pfeffer and Salancik, 1978; Zahra and Pearce II, 1989; Gopinath *et al,* 1994; Johnson *et al*, 1996; Maassen, 2002; Peng, 2004; Gabrielsson, and Huse, 2005; Luan and Tang, 2007) suggest that the outside board members (independent directors) in the board is an indication of board's resource dependence role which may link the firm with its environment in achieving its various organizational goals. Outside directors have advance pragmatic qualifications, expertise and experience and thereby can effectively influence the board's decision and ultimately can add value to the firm (Fields and Keys, 2003). They also provide important monitoring functions in an attempt to resolve the agency conflict between management and shareholders (Bathala and Rao, 1995). Independent directors can play a useful role in relation to strategic planning risk management (Farrar, 2005). "…….outside directors may contribute both expertise and objectivity in evaluating the manager's decisions" (Byrd and Hickman, 1992, p 126). They are good monitors as they are not the part of the management (Jensen and Meckling, 1976; Fama, 1980; Beasley, 1996). They are more vigilant as they mainly focus on the firm's financial performance, may dismiss the CEO following poor performance to maintain their personal reputation as directors (Finkelstein and Hambrick, 1996, p 225); can freely evaluate management's performance and act to remedy inappropriate and unacceptable situations (Kesner *et al,* 1986). In the absence of the outside directors the insider dominated board in one hand will get enormous powers and the board may abuse such powers; on the other hand without the expertise of the outside directors, the board may not be effective (Dalton and Daily, 1999). In this study it is argued that, the presence of outsiders (outside independent directors) in the board will ensure the board independence and such board may enhance organization legitimacy and performance by providing information and resources (Zahra and Pearce II, 1989; Gopinath *et al,* 1994; Maassen, 2002). Although some of the CEOs are found to be in involved in corporate malpractice that led to the corporate scandals in USA and elsewhere, it does not necessarily mean that CEO duality is a bad governance structure (Kang and Zardkoohi, 2005). It can be argued that the CEO duality and firm performance is contingent. The presence of outside independent directors may be valuable resources to the firm and it may greatly influence the firm economic performance within the dual leadership structure. Consistent with this theoretical perspective (resource dependence theory), this study argues that dual leadership structure will have no beneficial impact on firm performance without the resource dependence role of the board (having outside independent directors). Consequently this study proposes the following hypothesis:

> ***Hypothesis 1:*** *CEO duality is positively related to corporate performance in the presence of resource dependence role (having outside independent directors) in the board.*

5. Methodological Issues

5.1. Sample Selection

Based on the availability of company annual reports, this study considers 93 non-financial firms listed in Dhaka Stock Exchange for the period of 2000-2009, representing the 39.57% of the total listed companies as on 31st December 2009. It is also the 63.70% of the total non-financial companies representing almost 55% of the market capitalization of total non-financial companies. The sample also consists of variety of industries as per 'Standard Industrial Classification' (SIC) codes. The data of these selected companies is manually collected for the period of 2000-2005 (for pre-corporate governance notification) and 2006-2009 (for post-corporate governance notification). Dependant upon the availability of company annual reports, a total of 825 observations was made (table 1). Of the total observations, 557 observations are made for pre-corporate governance notification and 268 observations are made for post-corporate governance notification.

Table 1. CEO duality incidences in the sample

Year	Number of firms in the sample	Incidence of CEO-Duality	Incidence of CEO Non-Duality	Observed firm years
2000	93	50%	50%	92
2001	93	50.54%	49.46	93
2002	93	51.60%	48.40%	93
2003	93	50.54%	49.46%	93
2004	93	50.54%	49.46%	93
2005	93	49.46%	50.54%	93
2006	93	44.08%	55.92%	93
2007	93	41.76%	58.24%	91
2008	93	38.46%	61.54%	78
2009	93	33.33%	66.67%	6
Total				825

The audited financial report was the basis for obtaining the company's accounting information, such as EBIT, total assets, total liabilities and equities, preferred stock. The CEO duality, board composition and board size data were obtained from the respective company's directors' report. Market value of the closing share price was collected from Dhaka Stock Exchange web page (www.dsebd.org) and from the 'Monthly Review' of Dhaka Stock Exchange. The ownership data were obtained from notes to the financial statement, 'Corporate Governance Compliance Report' of the respective company and from the 'Monthly Review' of Dhaka Stock Exchange.

5.2. Variable Definitions

5.2.1. Dependent Variable: Firm Performance

Dependent variables in this study are the firm performance under different performance measures such as, the Return on Assets (ROA) and Tobin's Q. Consistent with Yammeesri and Lodh (2004) and Yammeesri *et al* (2006), Rashid and Lodh (2008), Rashid (2010), Rashid *et al* (2010), Return on Assets (ROA) is calculated as the Earnings before Interest and Taxes (EBIT) scaled by the book value of average net total assets. Tobin's Q, is the ratio of the market value of the firm to the replacement cost of their assets.

5.2.2. Independent Variable: CEO duality

The CEO duality is the situation when the board chair and the CEO or Managing Director holds the same position. CEO duality variable is a binary and defined as a variable of CEOD, which is equal to be one (1) if the post is hold by same person as the CEO and board Chair, otherwise zero (0).

5.2.3. Control Variables

A number of control variables, such as, board size, ownership structure, debt ratio, firm size, firm age and firm growth are considered. Board size has number of implications for board functioning and thereby firm performance (such as, Raheja, 2005; Coles *et al,* 2008). A board size may affect the monitoring ability of boards (Kula, 2005). A smaller board is manageable and plays a controlling function, whereas a larger board is non-manageable, may have greater agency problems and may not be able to act effectively leaving management relatively free (Chaganti *et al*, 1985; Jensen, 1993; Hermalin and Weisbach, 2003). "as board size increased, CEO domination of the board become more difficult and directors were in improved position to exercise their power in governing the corporation" (Zahra and Pearce II, 1989, p 311). A variable BDSIZE is considered as the natural logarithms of total board members.

Corporate ownership structure is one of the most important factors in shaping the corporate governance system of any country. It is argued that ownership structure plays a key role in determining firm's objectives, shareholders wealth and how managers of a firm are disciplined (Jensen, 2000; Yammeesri and Lodh, 2004; Yammeesri *et al*, 2006). CEO duality with the presence of managerial ownership may align the interest of CEO with that of shareholders (Barnhart and Rosenstein, 1998; Kholeif, 2008). Further, institutional investors can control the decisions and actions taken by CEO and limit the power of CEO when CEO and board Chair positions are combined (Kholeif, 2008). Following this and consistent with Pi and Timme (1993), Kula (2005), Elsayed (2007) and Kholeif (2008), this study considers directors (DIROWN) and institutional (INSTOWN) ownership as the control variables to identify the impact of ownership on board leadership structure and firm performance. Debt may act as disciplinary device, may reduce the shareholder-debtholder agency problem and may influence the performance (e. g. Jensen and Meckling, 1976). Therefore, consistent with this and following Elsayed (2007), this study considers the control variable debt ratio as disciplining effect on firm performance. Debt ratio is calculated as total debt scaled by total assets. Firm size is an important variable in influencing firm performance. Large firms have more capacity to generate internal funds (Short and Keasey, 1999); large firms have a greater variety of capabilities (Majumdar and Chhibber, 1999); large firms may also have problems of coordination, which may negatively influence its performance (Williamson, 1967). This study considers the natural logarithm of total assets as firm size (SIZE). Firm performance may also be influenced by firm age; the older firms are likely to be more efficient than younger firms (Ang *et al,* 2000). A variable of AGE is defined as the natural logarithm of the number of years firm have been listed on the stock exchange.

5.3. Regression Model Specification

The following model is developed in this study

$$Y_{i,t}=\alpha+\beta_1 CEOD_{i,t}+\beta_2 BDCOMP_{i,t}+\beta_3 BDSIZE_{i,t}+\beta_4 DIROWN_{i,t}+\beta_5 INSTOWN_{i,t}+\beta_6 DR_{i,t} +\beta_7 AGE_{i,t}+\beta_8 SIZE_{i,t} +\beta_9 GROWTH_{i,t}+\varepsilon_{i,t}$$

Where, $Y_{i,t}$ is alternatively $ROA_{i,t}$, and Tobin's $Q_{i,t}$ for *i*th firm at time *t.* $CEOD_{i,t}$ is the CEO duality for *i*th firm at time *t*, $BDCOMP_{i,t}$ is the board composition (proportion of outside to directors) for *i*th firm at time *t*, $BDSIZE_{i,t}$ is the natural logarithm of board size (representing the total number of directors) for *i*th firm at time *t*, $DIROWN_{i,t}$ and $INSTOWN_{i,t}$ is the percentage of shares owned by directors/sponsors and institutions respectively for *i*th firm at time *t*, $DR_{i,t}$ is the debt ratio measured as total debt to total assets for *i*th firm at time *t* and, $AGE_{i,t}$ is the firm's age for *i*th firm at time *t*, $SIZE_{i,t}$ is the firm's size for *i*th firm at time *t*. α is the intercept, β is the regression coefficient and ε is the error term.

5.4. Descriptive Statistics

Table 2 and 3 presents the descriptive statistics of the variables for pre-appointment of independent directors (2000 and 2005), post- appointment of independent directors (2006 and 2009) respectively.

Table 2. Descriptive statistics of the variables for pre-appointment of independent directors (N=557)

Variables	Mean	Minimum	Maximum	Std. Deviation	Skewness	Kurtosis
Return on Assets (ROA)	0.06	-0.18	0.34	0.07	0.16	1.68
Tobin's Q	1.11	0.17	4.30	0.58	2.23	7.03
CEO Duality	0.51	0.00	1.00	0.50	-0.02	-2.00
Board Size (BS)	5.97	3.00	11.00	1.83	0.59	-0.19
Director Share Ownership (DIROWN)	0.44	0.00	0.98	0.17	-0.17	0.91
Institutional Share Ownership (INSTOWN)	0.17	0.00	0.57	0.15	0.47	-0.88
Debt Ratio (DEBT)	0.71	0.02	3.62	0.47	2.71	11.33
Firm Age (AGE)	2.54	0.69	3.37	0.45	-0.50	-0.07
Firm Size (LogTA)	5.89	2.50	9.30	1.42	-0.10	-0.32
GROWTH	0.09	-1.00	12.06	0.66	11.93	204.31

Table 3. Descriptive statistics of the variables for post-appointment of independent directors (N=268)

Variables	Mean	Minimum	Maximum	Std. Deviation	Skewness	Kurtosis
Return on Assets (ROA)	0.05	-1.49	0.29	0.13	-6.28	69.21
Tobin's Q	1.28	0.34	6.23	0.78	2.57	9.75
CEO Duality	0.42	0.00	1.00	0.49	0.34	-1.90
Board Composition	0.10	0.00	0.33	0.08	-0.01	-0.78
Board Size (BS)	6.65	3.00	12.00	2.00	0.43	-0.38
Director Share Ownership (DIROWN)	0.42	0.00	0.96	0.19	0.05	0.53
Institutional Share Ownership (INSTOWN)	0.20	0.00	0.58	0.17	0.46	-0.88
Debt Ratio (DEBT)	0.78	0.07	5.62	0.63	4.04	22.15
Firm Age (AGE)	2.86	2.08	3.47	0.31	-0.10	-0.82
Firm Size (LogTA)	6.19	2.44	9.86	1.60	-0.07	-0.21
GROWTH	0.54	-1.00	104.33	6.40	16.08	261.47

The descriptive statistics include mean, minimum, maximum, standard deviation, skewness and kurtosis for normality test. The descriptive statistics of pre and post corporate governance reform (table 2 and 3) reveals that firm performance in terms of ROA has decreased from 6 percent to 5 percent; whereas firm performance in terms of Tobin's Q has increased from 111 percent to 128 percent. The average CEO duality has decreased from 51 percent to 42 percent. Average board size has increased from 5.97 to 6.65. Directors' stock ownership has decreased from 44 percent to 42 percent; whereas the institutional stock ownership has increased from 17 percent to 20 percent. Debt ratio has increased from 71 percent to 78 percent. Firms' growth in sales has increased from 9 percent to 54 percent.

For performing statistical analysis, there is a necessity to meet the assumptions of statistical analysis, such as normality, heteroscedasticity and multicolinearity. The assumption of normality is confirmed through a Normal Q-Q Plot, the Residual Test/Histogram-Normality Test as well both the 'Kolmogorov-Smirnov' and 'Shapiro-Wilk'. No multicolinearity problem is seen in this study as the correlation matrix of the explanatory variables (not shown here) shows that there is no strong correlation among the variables as

correlation coefficients are very small (less than 0.75 or negative) and Variance Inflation Factor (VIF) is less than 2. The Breusch–Pagan-Godfrey test suggests that there is a presence of heteroscedasticity in the model, which is corrected by using correction technique for unknown heteroskedasticity of White (1980).

6. Results

6.1. Explanatory Analysis

The explanatory analysis of CEO duality and firm performance under ROA and Tobin's Q performance measures are shown in figure 1 and 2 respectively. These figures reveal that in general the firms are over performing under the independent leadership structure under the ROA performance measure. The firms with CEO duality were over performing under Tobin's Q performance measure before announcing the 'Corporate Governance Notification'. However, there is a reversing trend of CEO duality immediately before the announcement of 'Corporate Governance Notification' (which is also evident from table 1 and figure 3). In other words, the CEO duality incidence is decreasing and many leaders changed their hats following the announcement of 'Corporate Governance Notification' (voluntary regulation of CEO non-duality). Although it is hard to say if the performance of dual leadership firms has improved following the adoption of resource dependence role of the board (appointment of outside directors), it can be argued that many firms which are in high performance group under market based performance measure may have complied the voluntary regulation of CEO non-duality (independent leadership structure). This is consistent with the argument that the vigilant boards may restrict the duality when firm performance is good and vice versa (see for example, Finkelstein and D'Aveni, 1994; Elsayed, 2007) and apparently resource dependence role of board (outside independent directors) may have prompted this.

Figure 1. Board leadership structure and firm performance under ROA performance measure

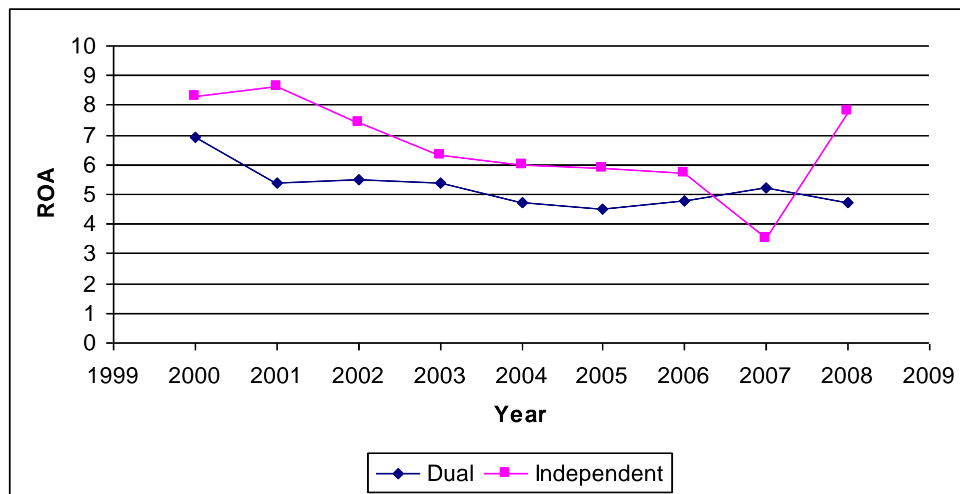


Figure 2. Board leadership structure and firm performance under Tobin's Q performance measure

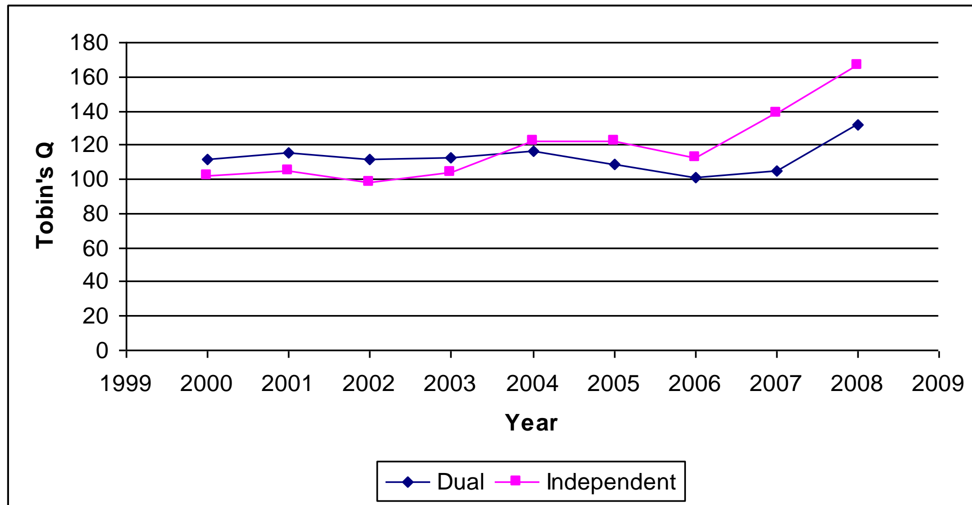
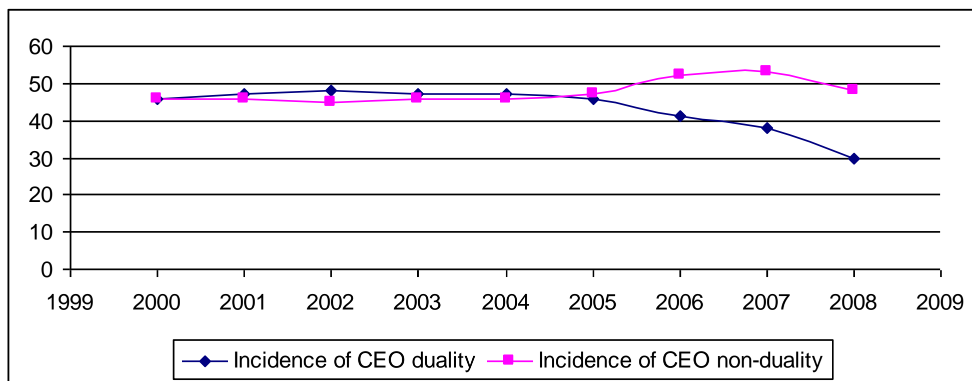


Figure 3. Incidence of CEO duality at different years.



6.2. Empirical Results

Table 4 presents the regression coefficients of the relationship between the CEO duality and corporate performance before appointing the outside independent directors. The results indicate that there is a negative (non-significant) relationship between CEO duality and firm performance under all the performance measures (although it is very weak, the coefficient is only 0.005 and 0.055 respectively). The results also indicate that 'board size' and director ownership have significant positive explanatory powers in influencing firm performance under both the performance measures.

Institutional ownership and firm size have significant positive explanatory power in influencing firm performance only under ROA performance measure. Debt has significant negative explanatory power in influencing firm performance under ROA performance measure and significant positive explanatory power in influencing firm performance under Tobin's Q performance measure. Firm age has significant positive explanatory power in influencing firm performance only under Tobin's Q performance measure. Based on both the explanatory and empirical analyses suggest that CEO duality have a negative impact on firm performance.

Table 4. Influence of CEO duality and firm performance under different performance measures for pre-appointment of independent directors

	Dependent Variables (Pre-Appointment of Independent Directors)		**Dependent Variables** (Post-Appointment of Independent Directors)	
	ROA	**Tobin's Q**	**ROA**	**Tobin's Q**
Intercept	-0.064 **	-0.828 ***	-0.095	-1.703 ***
	(-2.132)	(-4.273)	(-0.761)	(-5.119)
CEOD	-0.005	-0.055	0.007	-0.145 **
	(-0.882)	(-1.553)	(0.578)	(-2.594)
BDCOMP	0.069	0.067	0.250 ***	0.734 **
	(0.510)	(0.115)	(3.243)	(2.301)
BDSIZE	0.041 ***	0.315 ***	-0.012	0.396 ***
	(4.847)	(6.318)	(-0.372)	(4.051)
DIROWN	0.072 **	0.393 **	0.032	-0.152
	(2.767)	(2.098)	(0.789)	(-0.875)
INSTOWN	0.040 **	-0.079	-0.026	-0.465 **
	(2.039)	(-0.666)	(-0.602)	(-2.643)
Debt	-0.055 ***	0.725 ***	-0.079	0.915 ***
	(-7.937)	(21.096)	(-1.475)	(26.799)
AGE	0.010	0.271 ***	0.049 **	0.469 ***
	(1.432)	(7.293)	(2.415)	(4.212)
SIZE	0.006 **	0.009	0.009	0.055 **
	(2.262)	(0.673)	(1.640)	(2.816)
GROWTH	0.006	0.032	0.000	-0.003 **
	(0.688)	(0.932)	(-0.829)	(-2.573)
Adjusted R^2	0.225	0.468	0.201	0.647
F-Statistic	18.995 ***	55.329 ***	8.488 ***	55.321 ***
Observations	557	557	268	268

The *t*-tests are presented in the parentheses. * $p < 0.10$; ** $p < 0.010$; *** $p < 0.001$.

However, this finding may challenged following the argument that, board structure is an endogenously institution and its organization depends on a number of firm characteristics (such as, Barnhart *et al,* 1994; Hermalin and Weisbach, 2003; Linck *et al*, 2008; Bennedsen *et al*, 2008). Prior literature (such as, Boyd, 1995; Dalton *et al,* 1998; Worrell *et al,* 1997; Mak and Li, 2001; Braun and Sharma, 2007; Lam and Lee, 2008; Kholeif, 2008; Elsayed, 2009) argue that CEO duality and firm performance is contingent and it vary depending on the board size, ownership structure, firm size, firm age and proportion of outside independent directors as moderating variable or the choice of performance measures Consistent with the 'resource dependence' view (such as, Zahra and Pearce II, 1989; Gopinath *et al,* 1994; Maassen, 2002) this study argues that the presence of outside independent directors will enhance board power and independence and will ensure that the corporate decisions are made in the best interest of shareholders which in turn is associated superior corporate performance. Table 5 presents the regression coefficients of the relationship between the CEO duality and corporate performance following the appointment of outside independent directors in the boards.

It is noticed that following the adoption of resource dependence role there is a positive relationship (although non-significant) between CEO duality and firm performance under ROA performance measure; there is a significant negative relationship between CEO duality and firm performance under Tobin's' Q. It is also noticed that role of ownership has slashed following the adoption of resource dependence role by the board (appointment of outside directors) as the coefficients of both the DIROWN and INSTOWN is negative under all the performance measures. The finding implies that dual leadership structure has positive impact on firm performance under accounting performance measure; whereas independent leadership structure has significant positive impact on firm performance under market performance measure. More specifically the resource dependence role is apparent under dual leadership structure in accounting based performance measure.

Table 5. Influence of CEO duality and firm performance under different performance measures for high performance group

	Dependent Variables (High Performing Groups)				**Dependent Variables** (Low Performing Groups)			
	ROA		**Tobin's Q**		**ROA**		**Tobin's Q**	
Intercept	0.119	***	-0.283		0.007		0.161	**
	(4.193)		(-0.701)		(0.119)		(2.560)	
CEOD	-0.022	***	-0.193	**	-0.002		-0.003	
	(-4.528)		(-2.494)		(-0.240)		(-0.265)	
BDCOMP	0.055		0.287		-0.061		0.032	
	(1.378)		(0.694)		(-0.973)		(0.317)	
BDSIZE	0.011		0.085		-0.025	*	0.154	***
	(1.342)		(0.874)		(-1.811)		(7.186)	
DIROWN	-0.006		0.060		0.081	***	0.065	
	(-0.272)		(0.340)		(3.364)		(1.242)	
INSTOWN	-0.055	***	-0.619	***	-0.017		0.152	***
	(-3.218)		(-2.677)		(-0.574)		(3.433)	
Debt	-0.035	***	0.699	***	-0.050		0.579	***
	(-3.374)		(10.515)		(-1.527)		(19.366)	
AGE	0.012	*	0.309	**	0.005		0.010	
	(1.886)		(3.204)		(0.620)		(0.666)	
SIZE	-0.003		0.082	***	0.006		-0.003	
	(-1.206)		(3.223)		(1.427)		(-0.631)	
GROWTH	0.026	***	0.012		0.000		-0.001	
	(3.989)		(0.520)		(0.133)		(-1.316)	
Adjusted R^2	0.167		0.431		0.169	***	0.517	
F-Statistic	11.067	***	24.795	***	9.987	***	65.187	***
Observations	425		284		400	***	541	***

The *t*-tests are presented in the parentheses. * $p < 0.10$; ** $p < 0.010$; *** $p < 0.001$.

In the explanatory findings above (figure 1 and 2) it is noticed that many high performing firms leaders change their hats from dual leadership structure to independent leadership following the appointment of outside directors. From this, it is primarily evident that board of directors is less likely to approve the CEO duality when the corporate performance is high and vice versa (Such as, Finkelstein and D'Aveni, 1994; Dalton *et al,* 1998; Elsayed, 2007). It can be argued that the resource dependence role of the board may have prompted this. To explore this issue the firms are classified in two sub groups based on their mean performance. One group is titled as high performing group which performance is equal to or above the mean performance under ROA and Tobin's Q; another group is titled as low performing group which performance is below the mean performance under ROA and Tobin's Q.

It is noticed that there is a significant negative relationship between CEO duality and firm performance for high performing group and there is a negative (non-significant) relationship between CEO duality and firm performance for low performing group. It implies that there is a significant positive relationship between CEO non-duality and firm performance for high performing firms which are already in the independent leadership structure (see figure 2 and 3). There is a negative relationship (non-significant) between CEO duality and firm performance for low performing group.

7. Discussion and Conclusion

This study examines if the CEO duality influence the firm economic performance in Bangladesh and the moderating effects of board composition in the form of outside independent directors. It also examines the relationship between CEO duality and firm performance for high and low performing group. The finding is that there is there is a negative (non-significant) relationship between CEO duality and firm performance before appointment of outside directors in the board. However, following the adoption of resource dependence role (appointment of outside directors) relationship is found to vary under

accounting and market based performance measures. There is a positive (non-significant) relationship between CEO duality and firm performance under accounting based performance measure and significant negative relationship under market based performance measure. It implies that independent leadership structure has significant positive impact (resource dependence role) on firm performance under market performance measure. The board may have linked the firm with its external resources when there is an independent leadership structure. Further, when the CEO duality and firm performance is explored for high and low performing group, it is noticed that there is a significant positive relationship between CEO non-duality and firm performance for high performing firms which are already in the independent leadership structure (CEO non-duality). There is a negative relationship (non-significant) between CEO duality and firm performance for low performing group.

The theoretical implication of this study is that, this study supports the agency theory and resource dependence theory. However, there is a little evidence to support the stewardship theory. Practitioner implication of this study is that the leader of low performing group may consider changing their hat, or adopt independent leadership structure
This study may have some limitations. Such as, the data were data mainly collected from the company annual report. As the accounting standards are very poor in developing countries, the annual report may not truly represent the company's state of the affairs and performance. Further, the data are collected from the large number of observation of different corporate entities ignoring the underlying differences in organizations as in no way two organizations (even in the same industry) are same (Deegan, 2006). The extreme value of some observed variables such as, EBIT, accumulated profits of a few firms for certain years may severely impact the outcome of this study.

This study is conducted within the resource dependence perspective and it is argued that the firm performance may vary following the adoption of outside independent directors. It is also argued that board structure is an endogenously institution and its organization depends on a number of firm characteristics (such as, Barnhart *et al,* 1994; Hermalin and Weisbach, 2003; Linck *et al*, 2008; Bennedsen *et al*, 2008). This study ignored a possible link that the CEO duality and firm performance may vary across industries as this study has a combination of different industries in the sample and the industry effect of duality and performance is unknown (Donaldson and Davies, 1991; Dahya and Travlos, 2000; Mak and Li, 2001; Elsayed, 2007). Therefore, it is too early to make a conclusion and further study may be conducted examining the industry specific impact of board leadership structure and firm performance.

Notes:

[1] Bangladesh was a former British colony and it inherited the common legal systems based on English common law (as opposed to civil law). The two-tier board is common in civil law countries (Rose, 2005).
[2] This view suggests that regulation is required and the market might not always work in the best interest of society.

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MEASURING EARNINGS QUALITY: EVIDENCE FROM NEW ZEALAND

Dr Muhammad Nurul Houqe*, Tahmin Fatema Islam*

Abstract

We utilize two basic approaches to measure the quality of earnings which control two different dimensions of earnings management. The research design is structured primary on the basis of calculating two different measures of the quality of earnings on the industry level and on the company level. We calculate earnings quality for New Zealand public firms from the OSIRIS (http://www.osiris.com) database for 2004-2007. This research concludes that various stakeholders should apply more than one measure for the quality of earning in order to have strong evidence about the level of quality before taking any corrective action or making any decision related to that company. If one company is having low quality of earning according to one technique and high quality of earnings according to another, the stakeholders cannot have a final conclusion about that company and they need more investigations and analysis to assess the quality of earnings.

Keywords: Earnings Quality, Accounting Information, Financial Analysts

**School of Accounting & Commercial Law, Victoria University of Wellington*
Voice: + 64 4 4638340
Fax: + 64 4 4635076
Email: noor.houqe@vuw.ac.nz
***81 Allington Road, Karori, Wellington, New Zealand*

1. Introduction

The advent of corporate scandals at the beginning of the 21st century involving high profiled corporate citizens such as Enron and WorldCom in the United States and HIH in Australia has led to an increased call for more governance. This focus on good governance is especially strong from parties such as investors and shareholders who each have a financial stake in the on-goings of the company. Concerns were raised with regards to the litany of lies and deception perpetrated by those with authority from the higher echelon of companies that knowingly provide misleading "robust" information with regards to the state of the company's financials. In the Enron scandal, the fact that Arthur Anderson – the then largest professional services firm in the world was willing to go along with the upper management of Enron in concealing its wrongdoings has resulted in a public outcry for better mechanisms within companies to protect shareholder wealth.

The purpose of this paper is to empirically investigate the earnings quality in the context of New Zealand. In earnings management literature shows researchers usually design their research question as whether and when earnings management takes place. Earnings management is a form of earnings manipulation that is likely to reduce the quality of earnings that interference with the estimation process to misrepresent reality is, by definition, poor quality[1]. This relation is empirically established in the literature (Francis and

[1] Managers have some degree of flexibility and discretion in reporting their financial performance and they may use it either opportunistically to manage earnings (Christie and Zimmerman 1994) or they may use it to communicate private value-relevant information about the firm's future performance (Jones 1991; Healy and Palepu 1993). However, much of the extant literature finds that earnings management is carried out with the intention of either misleading financial statement users or of biasing contractual outcomes that depend on accounting earnings. Recent studies have provided evidence of income-increasing opportunistic earnings management related to initial public offerings (Teoh et al. 1998a; Teoh et al. 1998), seasoned public offerings (Teoh et al. 1998b), stock financed acquisitions (Erickson and Wang 1998), meeting analyst earnings expectations (Payne and Robb 2000; Burgstahler

Wang 2008; Hope et al. 2008; Wang et al. 1994; Ali and Hwang 1995; and Cheng et al. 1997). When mangers manage earnings for opportunistic purposes, accounting earnings become a less dependable measure of a firms‟ financial performance. Accordingly, it is justifiable to use earnings management as an indicator of the quality of earnings.

This research presents an empirical study on using two different approaches of measuring the quality of earnings on different industry. The notion is; if there is a complete consistency among the two measures, a general assessment for the quality of earnings (high or low) can be reached and, if not, the quality of earnings is questionable and needs different other approaches for measurement and more investigations and analysis.

The results show that different approaches of measuring the quality of earning lead to different assessment, and one industry or one company can not be labelled as having low or high quality of earning based on the result of one approach only. The results also suggest that the stakeholders before making any financing, investing decision or taking any corrective action have to use more than one approach to assess the quality of earnings.

The rest of the paper is organized as follows. The next section begins with accounting information and earnings quality and we than develop our model in Section 3. In Section 4 we describe the sample selection procedure and results and section 6 we present our conclusion.

2. Accounting information and earnings quality

Cheng et al (2005) document that significant difference in impact on earnings from the choice of treatment of transition obligation; the accounting choice has no significant impact on the total value relevance of earnings and book value. When immediate recognition method is applied, investors ignore the one time change of transition obligation, and rely more on book value in the valuation of a firm. However, when prospective recognition method is applied, both earnings and book value are value-relevant in the adoption year and also in the subsequent year. The value-relevance stream of research is based on the premise that if information is useful, investors will adjust their behaviour and the market will respond quickly through changes in share prices. Therefore, information is considered relevant if share returns are associated with the release of the information. The quality of accounting earnings is based on the understanding that accounting earnings, as a performance measure, are value relevant (e.g. Beaver 1998; Lev 1989). There has been significant range of studies, since Ball and Brown (1968), empirically showing the importance of quality of accounting earnings as value-relevant information for investors (e.g. Easton and Harris 1991; Collins and Kothari 1989). A primary research design consideration for value relevance research is the selection of the model used in the tests. Liner information dynamics model (e.g. Ohlson model 1995) expresses firm value as the sum of the book value of equity and the present value of future abnormal earnings (Ota 2001). Thus, if share prices are a linear function of only book value of equity and expected abnormal earnings, then share returns are a linear function of level of earnings and change of earnings. Earnings level, ceteris paribus, is derived from change in book value and change in earnings is derived from the movement of earnings level from period t_0 to t_1. Thus, the Easton and Harris (1991) returns model is a measure of the change in price from period t_0 to t_1 relative to the change in the Ohlson (1995), liner information dynamics model.

The value-relevance of a particular firm's accounting earnings depends on the ability of current accounting earnings to facilitate the prediction of future returns by predicting future earnings and cash flows. Quality earnings are price informative, because empirical evidence shows that reliable measures of future earnings and cash flows (i.e. permanent earnings) provide quality accounting information (Cheng et al 1996 & 1997). Although the market places greater emphasis on quality earnings (Freeman and Tse 1992), it is hard for shareholders to observe the quality of earnings. Alternatively, shareholders use cues to guide the assessment of earnings quality. The cues should be those that affect the actual earnings quality.

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and Eames 2006), meeting management forecasts (Kasznik 1999), and avoiding earnings decreases and losses (Burgstahler and Dichev 1997). Examples of settings leading to income-decreasing earnings management include management buyouts (DeAngelo 1988; Perry and Williams 1994), executive compensation (Healy 1985; Holthausen et al. 1995), and appeals for import relief (Jones 1991). This body of research has found convincing evidence of opportunistic earnings management in settings where strong incentives to manage earnings exist.

Current generally accepted accounting principles provide sufficient latitude in allowing firms to selectively use principles and procedures in communicating firm performance to stakeholders. This is important because of asymmetric informational advantage over other users of accounting information. Therefore, they can use their knowledge to select procedures, estimates and disclosures to suit the firm's short-term goals often to the detriment of long-term ones. This could potentially decrease accounting as a relevant and credible form of communication. Opportunistic use of judgment also creates opportunities for "earnings management" in which managers choose reporting methods and estimates to bias accounting numbers to extract private benefits and/or to mask true firm performance.

Zarowin (2002) applies Leuz et al (2001) framework to examine whether income smoothing makes stock price more informative. He uses two smoothing measures, namely (i) correlation between changes in accruals and cash flows, and (ii) dispersion in net income (S.D. of net income) divided by dispersion in cash flow (S.D. of cash flow). He than regress current stock returns on lagged, current and future earnings (cash flows) and find that stock returns of firms with more smoothing tendency capture more information about future earnings (future cash flows). However, Zarowin's study only examines earnings smoothing measures does not consider the impact of earnings management measures. On the other hand Habib (2004) consider both (smoothing and discretion) measures of earnings management to empirically examine the association between the quality of earnings information communicated to investors and its impact on value relevance of accounting information in the context of Japan. Results based on 5,318 consolidated firm-year observations over 1992-1999 show that, both earnings management measures and aggregate earnings management measures (combination of both earnings smoothing and earnings management measures) are significantly negatively associated with the combined value relevance of book values of equity and earnings (combined model) and value relevance of earnings (earnings model).

3. Model development

There is no established generally accepted approach to measuring earnings quality. In this study we utilize two basic approaches to measure the quality of earnings which control two different dimensions of earnings management.

The first approach is focusing on the variability of earnings based on the idea that managers tend to smooth income because they believe that the investors prefer smoothly increased income. The notion of this approach is the relative absence of variability – is sometimes associated with higher-quality earnings. Leuz et al. (2003) measures the variability of earnings by calculating the ratio of the standard deviation of operating earnings to the standard deviation of cash from operations (smaller ratios imply more income smoothing).

The second approach is focusing on the ratio of cash from operation to income, this measuring of earnings quality is based on the notion that the closeness to cash means higher quality earnings, as mentioned by Penman (2001), this is the simplest technique to measure the earnings quality.

The model will use these two approaches to measure the quality of earnings, the notion is; the result of each measure will be different based on the type of industry, market capitalization, number of employees, and many other factors. If one industry (company) is showing low quality of earnings according to the two approaches, that will confirm the existence of earnings management in that industry (company). On the other hand if there is no consistency among the three measures for one industry or company, the quality of earning will be questionable and needs further investigations and analysis. Finally, if there is consistency among the two measures for one industry (company) that will confirm that the accounting information represents the real economic performance of the industry without any interference from the management.

Table I. Presents the two-dimension model.

Leuz et al (2003) approach	Penman (2001) approach
Quality of earnings is measured by variability of earnings which is equal to the standard deviation of operating income divided by the standard deviation of cash flow from operation. The smaller the ratio the lower the quality of earnings.	Quality of earnings is measured by the ratio of cash flow from operation divided by the net income. The smaller the ratio the higher the quality of earnings

4. Sample and statistical results

The research design is structured primary on the basis of calculating two different measures of the quality of earnings on the industry level and on the company level. The analysis is directed at testing whether there is consistency among the two measures for one industry or one company in order to have strong evidence about whether the quality of earnings is low or high. The quality of earnings will be marked as questionable if there is no consistency among the two measures. In this case, the quality of earnings measures needs more analysis and investigations and may be in some cases different techniques to confirm whether it is high or low.

We calculate earnings quality for New Zealand private and public firms from the OSIRIS (http://www.osiris.com) database for 2004-2007, the available complete data was for only 129 companies. Table II presents classification of the companies according to their activities.

Table II. Industrial classification

Industry	**# Companies**	**% of sample**
Agriculture & livestock	10	7.75
Financial services	12	9.30
Investment	08	6.20
Manufacturing	27	20.93
Power gas oil and mining	07	5.43
Service	51	39.54
Technology	14	10.85
Total	**129**	**100**

Table III represents the results of the empirical study for the industry level. As shown in table III, there is a consistency among the two measures of the quality of earnings for the financial services companies, the manufacturing companies, the power gas oil and mining companies and for the technology companies. For the full same, the agriculture companies, the investment companies, the service companies quality of earnings is questionable and cannot be assessed based on the these two measures.

Table III. The empirical study results: Industry Level

Industry	N	Leuz et al (2003)		Penman (2001)		EQ
		Measure <1 L >1H	EQ	Measure <3 H >3L	EQ	
Full sample	129	5.02	H*	15.97	L	Q***
Agr. &Live	10	9.30	H	10.61	L	Q
FinSrvices	12	.14	L**	4.87	L	L
Investment	08	.92	L	1.81	H	Q
Mfg	27	1.40	H	1.63	H	H
Gas Oil	07	1.11	H	2.97	H	H
Service	51	1.22	H	-2.31	L	Q
Technology	14	.322	L	-4.38	L	L

* High quality earnings;** Low quality earnings;*** Questionable earnings

Table IV presents the empirical study results for the company level. As shown in Table IV, the Agriculture & Livestock industry has one company (10 percent) with high quality of earnings, three companies (30 percent) with low quality earnings, and six companies (60 percent) their quality of earnings measure is questionable and cannot be assessed based on this model and needs further investigation and analysis.

Financial services industry, there are four companies (33 percent) with high quality earnings, six companies (50 percent) with low quality of earnings, and two companies (17 percent) with questionable measure for the quality of earnings.

Investment industry (property investment mainly), there are two companies (25 percent) with high quality of earnings, two companies with low quality of earnings, and four companies (50 percent) their quality of earnings is questionable.

Manufacturing industry, there are 15 companies (56 percent) with high quality of earnings, two companies (7 percent) with low quality of earnings, and ten companies (37 percent) with questionable quality of earnings.

Power gas oil and mining industry under Leuz et al (2003) approach two companies (29 percent) with high quality of earnings on the other hand Penman (2001) approach six out of seven companies with high quality of earnings. Finally seven companies in this industry produced questionable quality of earnings.

Service industry, there are twenty companies (38 percent) with high quality of earnings, five companies (10 percent) with low quality of earnings and twenty seven companies (52 percent) with questionable quality of earnings.

Technology industry five companies (38 percent) with high quality of earnings, five companies (38 percent) with low quality of earnings, and three companies (24 percent) with questionable quality of earnings.

Table IV. The empirical study results: company Level

No.	Symbol	Leuz et al (2003)		Penman (2001)		Overall EQ
		Measure	EQ	Measure	EQ	
Panel A: Agriculture and livestock companies						
1	AFL	.28	L	3.04	L	L
2	DGL	5.81	H	-.56	L	Q
3	FCGL	4.87	H	4.30	L	Q
4	LICL	.69	L	2.87	H	Q
5	NZW	.03	L	.82	H	Q
6	OBM	1.58	H	2.23	H	H
7	SCG	.17	L	2.10	H	Q
8	SKI	.54	L	1.5	H	Q
9	SFF	.63	L	8.26	L	L
10	TL	.01	L	-1.84	L	L
Panel B: Financial service companies						
1	BFL	.10	L	-6.67	L	L
2	CHL	.95	L	.76	H	Q
3	LGL	.32	L	-2.63	L	L
4	NCIL	1.75	H	-.46	L	L
5	NZX	2.52	H	1.90	H	H
6	PWL	.37	L	.91	H	Q
7	PFGL	.41	L	9.93	L	L
8	PGCL	3.28	H	1.37	H	H
9	RL	.05	L	5.23	L	L
10	SEC	1.19	H	2.18	H	H
11	WPL	.31	L	-.14	L	L
12	WEL	1.29	H	.89	H	H
Panel C: Investment companies						
1	CPNZ	.88	L	1.16	H	Q
2	CDL	.59	L	.76	H	Q
3	KIPT	2.48	H	.57	H	H
4	NPT	1.91	H	4.61	L	Q
5	PIL	1.82	H	.04	H	H
6	RPL	.35	L	9.04	L	L
7	RHL	.80	L	1.72	H	Q
8	TTPL	.06	L	-3.17	L	L
Panel D: Manufacturing companies						

1	BLIS	.85	L	.88	H	Q
2	B-ZL	.66	L	.10	H	Q
3	CCL	.65	L	1.30	H	Q
4	CGL	1.51	H	.54	H	H
5	CMCL	.55	L	1.13	H	Q
6	CL	.23	L	-1.77	L	L
7	EGL	3.26	H	.90	H	H
8	FPH	.95	L	1.96	H	Q
9	FBL	1.81	H	1.34	H	H
10	HHL	2.12	H	.91	H	H
11	IL	1.36	H	2.05	H	H
12	LPCL	1.59	H	1.59	H	H
13	MFL	2.55	H	.77	H	H
14	ML	1.26	H	1.03	H	H
15	MLC	.83	L	3.39	L	L
16	NPCL	2.99	H	.16	H	H
17	NIL	.43	L	1.38	H	Q
18	PTL	.87	L	1.13	H	Q
19	SL	5.13	H	1.03	H	H
20	STL	.47	L	1.90	H	Q
21	SHL	1.29	H	.90	H	H
22	SPNZ	6.04	H	1.89	H	H
23	STHL	6.34	H	1.66	H	H
24	TAL	2.76	H	1.34	H	H
25	UNL	.81	L	1.30	H	Q
26	WDTL	1.08	H	1.03	H	H
27	WTL	.96	L	.48	H	Q
Panel E: Power gas oil and mining						
1	CEL	.81	L	1.72	H	Q
2	HGNZ	.87	L	.51	H	Q
3	HEDL	.98	L	1.54	H	Q
4	NZOG	2.77	H	-1.53	L	Q
5	NZRC	.79	L	2.06	H	Q
6	TPL	.80	L	1.53	H	Q
7	ZML	2.43	H	.50	H	Q
Panel F: Service companies						
1	A2CL	.97	L	.53	H	Q
2	AHGL	1.68	H	1.93	H	H
3	ANZL	9.84	H	-0.86	L	Q
4	AWFG	2.28	H	1.27	H	H
5	AFL	.67	L	24.63	L	L
6	AHHL	.68	L	2.83	H	Q
7	BAHL	.42	L	.89	H	Q
8	BSPG	5.34	H	2.97	H	H
9	BGL	4.05	H	1.33	H	H
10	BIL	5.96	H	-1.61	L	Q
11	CGL	.53	L	-1.05	L	L
12	CMS	1.49	H	1.14	H	H
13	CGL	1.02	H	1.67	H	H
14	DBBL	.84	L	1.49	H	Q
15	EHFG	3.01	H	-.08	L	Q
16	EL	.42	L	.21	H	Q
17	ETTL	.97	L	.23	H	Q
18	FPAH	.37	L	1.26	H	Q
19	FL	1.57	H	1.58	H	H
20	GRDC	.62	L	.57	H	Q
21	HGHL	.79	L	1.37	H	Q

22	ICPB	.47	L	1.03	H	Q
23	JWIL	1.00	H	1.35	H	H
24	KGL	1.00	H	-.70	L	Q
25	KICL	.65	L	1.18	H	Q
26	KSL	2.18	H	2.84	H	H
27	LPL	4.90	H	.33	H	H
28	MTG	2.52	H	.35	H	H
29	MIL	4.24	H	1.14	H	H
30	MCH	.48	L	3.41	L	L
31	MCL	.45	L	5.14	L	L
32	MCHL	4.93	H	2.10	H	H
33	NPL	.96	L	.87	H	Q
34	NWSI	.92	L	2.57	H	Q
35	PEBL	4.10	H	.70	H	H
36	PPGL	.33	L	1.65	H	Q
37	PL	1.03	H	3.09	L	Q
38	PPL	1.72	H	1.12	H	H
39	RL	.42	L	2.15	H	Q
40	SCL	2.02	H	.23	H	H
41	SCEG	.22	L	2.19	H	Q
42	SNTL	2.67	H	-9.57	L	Q
43	SL	2.30	H	.32	H	H
44	SCGL	.30	L	.88	H	Q
45	STHL	.84	L	.85	H	Q
46	TGL	3.85	H	3.51	L	Q
47	THL	.64	L	4.92	L	L
48	TGL	.66	L	2.11	H	Q
49	WHL	4.67	H	2.05	H	H
50	WGL	.87	L	2.14	H	Q
51	AIAL	1.30	H	1.40	H	H
52	RBNZ	2.17	H	2.49	H	H
Panel G: Technology companies						
1	CTL	.16	L	-1.52	L	L
2	CL	3.46	H	.28	H	H
3	FSL	1.35	H	2.66	H	H
4	PSMS	.48	L	.97	H	Q
5	PL	.26	L	-1.04	L	L
6	RL	1.26	H	.89	H	H
7	RCL	.31	L	-3.76	L	L
8	SEIL	1.24	H	-3.78	L	Q
9	SDL	.88	L	-1.57	L	L
10	TTL	2.21	H	2.52	H	H
11	TCL	1.13	H	3.05	L	Q
12	VL	.72	L	4.60	L	L
13	ZGL	1.65	H	1.28	H	H

* High quality earnings; ** Low quality earnings;*** Questionable earnings.

These results suggests that the various stakeholders before reaching any conclusion about the quality of earnings of the company, they should have a complete consistency among different measures from different perspective; otherwise the quality of earnings needs more investigation and research.

5. Conclusion

This research presents an empirical study about the use of different measure of quality of earnings on different industries. The notion is since there is no agreed-upon definition or technique to measure the quality of earnings, one company or one industry cannot be labelled as having low quality of earnings based on one technique of measurement.

In another words, the company or the industry can be judged as having low or high quality or earnings only if there is consistency among the results of more than one approach or technique for measurement.

This research concludes that the various stakeholders dealing with the company should apply more than one measure for the quality of earning in order to have strong evidence about the level of quality before taking any corrective action or making any decision related to that company. If one company is having low quality of earning according to one technique and high quality of earnings according to another, the stakeholders cannot have a final conclusion about that company and they need more investigations and analysis to assess the quality of earnings.

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IN SEARCH FOR THE DETERMINANTS OF SHARE REPURCHASES POLICIES IN THE ITALIAN EQUITY CAPITAL MARKET: AN EVENT STUDY

Vincenzo Capizzi*, Renato Giovannini**

Abstract

In the last decade the number of buyback transactions involving listed companies in the Italian equity capital market has experienced a huge growth. However, no clear understanding of this phenomenon has yet been reached, also because of the limited information available on such financial decisions. The purpose of this paper is to check the main hypotheses behind the determinants of share repurchases, analysing the effect of own share buyback announcements specifically on the performance of the listed companies before and after the discontinuity introduced in Italy through the Reform of the financial markets. The first major outcome coming from the empirical analysis deals with the strong incentive played by the reform mentioned above, which introduced stricter corporate governance criteria, leading to a sharp increase in the volume and frequency of share buyback announcements, as well as in the number of companies getting access to this instrument. Secondly, the analysis strongly supports the replacement hypothesis theory, which states that buybacks have become a better substitute for dividends as a remuneration policy for shareholders.

Keywords: Corporate Governance, Corporate Board, Shareholder, Shares, Buyback

Jel code: G31, G32, G34

* *Department of Business Studies and Environment, Eastern Piedmont State University, Novara, Italy*
Email: vincenzo.capizzi@eco.unipmn.it
** *Department of Economics and Management, Guglielmo Marconi University, Rome, Italy*
Email: r.giovannini@unimarconi.it

1. Introduction

In recent decades, in the Italian capital markets and other main industrialised countries, especially the United States, there has been a steady growth of the number of companies which have started to remunerate their shareholders purchasing their own shares (*buybacks* or *share/equity repurchases*), instead of the more traditional form of the distribution of dividends.[2]

As shown in table 1, in the United States stock market, where this phenomenon was first observed, the volume of buybacks has remained consistently above 40% of the total of the dividends distributed since the second half of the 20th century. This percentage rarely exceeded 10% in the previous fifteen years. Furthermore, in recent years buybacks have almost equalled dividends as an instrument for remunerating shareholders.

However, with regard to buybacks, it is important to remember that, despite the framework of progressive legislative harmonisation, there are significant differences in the laws of different countries, and one reason which can explain the increase in buybacks can be found specifically in the opening and the progressive liberalisation of buybacks by different countries.[3]

[2] See Bagwell and Shoven (1989), Fama and French (2001), Grullon and Michaely (2002), Dallocchio and Salvi (2005).
[3] See Grullon and Ikemberry (2000).

Table 1. Shareholder remuneration policies of companies listed on the NYSE in the period 1974-2005: dividends vs. Buybacks

Year	Dividends ($ bln)	Own shares ($ bln)	Own shares/ Dividends
1975	33,0	0,8	2,4%
1980	64,1	6,6	10,3%
1985	97,7	20,3	20,8%
1990	165,6	36,1	21,8%
1995	254,2	99,5	39,1%
2000	379,6	158,1	41,6%
2001	416,6	177,4	42,6%
2002	142,2	106,3	74,8%
2003	158,2	108,7	68,7%
2004	220,1	199,8	90,8%
2005	163,3	348,7	213,5%

Source: Developed by the Authors on Bloomberg data

In some countries, in fact, this operation was banned and has been restored only recently[4], while in countries whose laws made the buybacks legal, deregulation has been introduced in order to encourage companies to use this instrument as an alternative to dividends or as a tool to reduce volatility of stock prices. It should be pointed out that buybacks[5] allow to both maximise equity value to shareholders and to improve its financial performance ratio, thanks to the decrease in the amount of capital invested[6]. A deeper analysis of this phenomenon shows that there isn't a primary reason for companies to buy their own shares; nevertheless, the main explanation given by most experts is that buybacks are often used by managers to send optimistic signals to the market concerning the future outcomes of the company. There are two main reasons in support of this explanation: the first is that the management seeks to transmit its own expectations of future increases in profits and cash flows and that these expectations are not shared by the market; the second, however, sustains that the management does not mean to communicate new information to the market, but expresses its own disagreement with the market's assessment of company's performance. In both cases, the management observes that its own company shares are undervalued.[7] For this reason we decided to conduct an extended research on the behavior of listed Italian companies, which investigates the impact of buyback announcements on the Italian market in the last fifteen years. The effect of the replacement of the dividend policy was also examined, in order to provide a specific assessment of the effects of the innovations introduced by the Draghi law concerning the execution procedures of buyback transactions. Specifically, this law significantly changed the previous regulations and is thought to be the basis of a new perception from the market of the reasons underlying buybacks. The main results of the empirical analysis can be summarised as follows: after the introduction of the Draghi law, the volume and frequency of buyback transactions increased considerably, as did the number of companies which have used this instrument; the typical reaction of the market to buyback transactions, which is reflected in the anomalous yields (calculated in a timeframe of 120 days), was reversed after the Draghi law was enforced: positive returns have replaced negative returns; after the reform of the financial system, a negative correlation has been observed between the dividend policy (payout) and buybacks, providing strong arguments in support of the theory of the replacement hypothesis, on whose basis

[4] Countries like Germany, Austria, Japan, Hong Kong and Taiwan have taken actions in this regard.

[5] For the most widely discussed reasons behind buybacks, see: Wansley *et al*. (1989) according to which the management declares the main reason to be, respectively, the undervaluation of securities and the opportunity of making a convenient investment; the review presented by Weston and Siu (2002), in which it is maintained that there are several reasons for buybacks, which have progressively changed in the last twenty years; Grullon and Ikemberry (2000).

[6] See also Nohel and Vefa (1998), according to whom buybacks are used as an instrument to reduce the size of the company and, therefore, to use the capital more efficiently.

[7] The difference between the two versions depends on the non-coincidence between price and fair value. In the first case, the company is unable, before the buyback, to convincingly communicate its prospects to the market; in the second case the market is inefficient, not succeeding in expressing prices which incorporate all the available information on the company.

buyback operations are becoming the preferred remuneration policy of investors; the empirical analysis of market values and the buyback policy adopted by the sample companies analysed confirms the undervaluation hypothesis, according to which buyback operations are announced only when the market price of the securities does not include their intrinsic value, making the purchase of own shares an excellent solution for remunerating shareholders and creating value at the same time.

2. Reasons in support of buybacks: an analysis of the main theoretical lines of thought

The buyback issue is certainly one of the most studied questions of corporate finance, especially in Anglo-Saxon contexts where, given the efficiency and representative nature of stock markets, valid empirical assessments can be made. There are many theories that, over time, have attempted to identify the reasons for buybacks. In short, these reasons can be identified by considering the different types of strategies and managerial choices listed below: corporate board and financial policy choices; shareholder remuneration policy choices; value creation-distribution choices.
The main theories in support of the above lines of thought are discussed below.

2.1. Buybacks and financial policy choices

It is well known, dealing with the theory of the separation of company ownership from its control,[8] that if, on one hand, rational arguments can be given in favour of the personalisation of the company in the form of the founding shareholders and/or current shareholders, on the other hand, conditions are created for the possibility, which is anything but theoretical, for the management to put its own interests before those of the shareholders. This can also, and above all, occur through the use of the financial resources in non-remunerative activities, aimed at increasing the company's tangible assets and its size, to the detriment of its profitability and value to the shareholders. The costs generated by this conflict between growth and maximising value are known in finance circles as free cash flow costs.[9] To effectively solve this problem, companies which have more liquidity than their financial management needs, in the absence of investment projects with net positive yield, can resort to buyback transactions, distributing value to the shareholders instead of, or in addition to, issuing dividends.[10] In other words, the buyback operation is a way of sending "signals" to the market aimed at reducing agency costs in the case of excess free cash flows, since the company is communicating that it does not intend to invest the excess liquidity simply to increase the size of the company and therefore keep all of its resources under full managerial control.[11] Other papers have attempted to verify whether share buybacks are partly motivated by agency costs. Denis *et al.* (1994) shows the role of debt in adding value by reducing excess investments. In a more recent study, the findings of Lie (2000) indicated that the companies which announce buybacks have higher cash levels than competitors and that the market reaction is directly linked to the company's excess cash. Furthermore, in the case of buybacks on the open market, the market reaction to such events is negatively correlated to the ROI of the company's investments. This demonstrates the favourable market reaction to buyback programmes announced by companies whose investment opportunities seem to have decreased over time. The "*Free Cash Flow Hypothesis*" would therefore explain one of the empirical rules linked to buybacks, which is a positive reaction to the announcement of the operation, with an increase in the value of the securities.[12] The framework of financial policies also includes buyback programmes launched with the aim of changing the company's leverage ratio to a level considered as optimal, in order to maximise the company's market value; in such cases, the buybacks are financed by loans, thus changing the issuing company's debt/equity ratio. According to Grullon and Ikemberry (2000), a similar objective is achieved through buyback operations carried out in the form of repurchase tender offers, in which it is explained to the market that the company's intention is to withdraw a significant part of its own shares in order to increase its leverage. This aim is more or less intrinsic to

[8] See Berle and Means (1932).
[9] See Jensen and Meckling (1976), Jensen (1986).
[10] See Easterbrook (1984); Miller and Rock (1985); Jensen, (1986); Allen and Michaely (2003); Fried (2005).
[11] See Jensen (1986). For interesting empirical evaluations, see also Nohel and Vefa (1998); Macchiati, Providenti and Siciliano (1999); Arosio, Bigelli and Paleari (2000).
[12] In the interviews and in the press releases announcing the buyback programmes, the management states that the purpose is to increase profits per share, and investment bankers and analysts who promote and comment on the buyback operation assuming the so-called "EPS bump", one of the main benefits linked to the buyback, are often on the same wavelength.

purchases carried out in the form of open market repurchases, which – as will be seen in paragraph 3 below - have generally smaller dimensions than public offers. It can also be argued that, given the predominance of open market repurchases compared to other forms of repurchases, this is not one of the main reasons, also because it can be achieved thanks to other policies. It would seem, on the other hand, that companies can carry out operations in order to calibrate their leverage ratio through open market repurchases also to compensate the effect of dilution connected to the implementation of stock option plans reserved to the management.[13] According to the "Leverage Hypothesis", the buyback operation announcement will have a positive effect on market capitalisation if the repurchase is financed by debts.[14] Following this system, the companies obtain tax savings because of the change in the financial structure, reporting expected cash flows to the market which are sufficient to absorb the greater debt level. This decision would, in any case, be based on the management's awareness of the undervaluation of the securities involved and the manoeuvre is therefore a convenient investment for the company. It is worth noting that the leverage ratio, which changes the financial structure, also influences relations between creditors and shareholders. This relationship is explained in the "Bondholder Expropriation Hypothesis", which states that a buyback announcement has a positive impact on prices as a consequence of the transfer of creditors' wealth to company shareholders.[15] In an Italian context, the law allows for a maximum purchase of 10% of own shares, which mitigates the possible link between buybacks and the objective of significant changes to the company's degree of leverage. Again, with regard to financial policies, buyback may be adopted as a manoeuvre intended as a means of defence against hostile takeover attempts.[16] In this respect, the buyback can be carried out in two separate stages: an initial stage aimed at preventing the takeover and a second phase aimed at contrasting it. In the preventive stage, the buyback enables control to be consolidated and, especially, shares to be removed from the market.[17] In the contrast stage, the buyback, through an increase in the market value of the shares, can be interpreted as a real defensive stratagem aimed at increasing the takeover cost and raising doubts as to whether the takeover should be pursued by the raider.[18] In addition, the shares bought back also enable a subsequent exchange of stock, i.e. operations in which the two companies exchange blocks of their own shares held in their respective portfolios. Lastly, the repurchase of own shares can precede future mergers and takeovers carried out as a form of payment, allocating shares of the buyer/incorporating company instead of distributing cash dividends.[19]

2.2. Buybacks and shareholder remuneration policy choices

The dividend policy involves a series of financial decisions adopted in relation to the yield on the share capital: the distribution of profits in the form of dividends, the purchase of own shares, the distribution of company shares or those of its subsidiaries free of charge, the breakdown of the nominal value of the securities and the payment of dividends in kind.[20] In this sense, buybacks can be a wise and valid alternative to the distribution of dividends based, firstly, on the different tax rates applied to dividends and to capital gains. In fact, investors who decide to sell their shares in the case of a buyback are taxed on their capital gains. Shareholders who keep their investment receive a pro-rata increase in the value of the company stock which they hold, without having to pay any immediate tax. Although the benefit of lower tax rates on capital gains compared to those on dividends may vary periodically, it is always positive. It is no coincidence that several papers highlight, on one hand, a positive correlation between the aggregate stock repurchase expense and, on the other hand, the entity of the capital gains tax benefit compared to

[13] See Chan, Ikemberry and Lee (2004).

[14] See Ross (1977); Masulis (1980); De Matos (2001); Bratton (2004).

[15] See De Matos (2001); Allen and Michaely (2003).

[16] On this subject, see Stulz (1988); Bagwell (1991); Dittmar (2000).

[17] Furthermore, if the purchase is financed by debt, an advantage can result from the change in the leverage ratio; in fact, for the raider, generally indebted, the appeal of the target company would decrease, due to both the minor liquidity and to the increased number of creditors who could claim the ownership rights of the target company.

[18] In the same stage, the purchase of own shares within the context of a greenmail programme would allow the majority shareholder of the target company to avoid losing control, albeit at a high cost. In fact, the Greenmail strategy consists of the resale to the issuer of a significant block of shares with a high premium, which allows the latter to avoid being subjected to a hostile takeover. The raider-seller of the shares effectively forces the target company to repurchase its shares, threatening a potential hostile takeover.

[19] With regard to extraordinary financial operations, see Confalonieri (2005), Forestieri (2005).

[20] This is how the most important literature on corporate finance portrays the dividend policy; see, for example, Brealey, Myers , (2003); Cattaneo (1999).

dividends.[21] This differential could be one of the several reasons to explain the increase in buybacks, especially in relative terms, compared to dividends. In literature, is made reference to a "dividend replacement" effect. According to the "Dividend Hypothesis", a buyback announcement would therefore have a positive effect on prices, since the market has a positive opinion of this kind of capital gains, which are taxed much more favourably than dividends.[22] However, according to an alternative hypothesis, the apparent purpose of the buyback would be a one-off distribution of resources rather than an extraordinary dividend, thus enabling a dividend stabilisation policy, i.e. without influencing the normal flow of dividends. In this sense, the buyback would give the market a different signal to that of an increase in dividends. For this reason, it is known that companies prefer to maintain dividends stable over time, changing them only in case of a stable increase in profits, which would make possible a long term stable dividend policy. Extraordinary dividends would not therefore be a correct instrument for distributing temporary excess liquidity to the shareholders, since would be sent a wrong signal to the market. The purchase of own shares, conversely, is a more flexible tool for remunerating shareholders, resulting in a reduction of the share base and improving the economic and financial performance indicators, such as profits per share and unit dividends. On closer consideration, a buyback can be compared to the alternative distribution of a dividend only if the company subsequently voids the shares. In fact, it can be demonstrated that the distribution of a certain sum in the form of dividends, or its use to buy shares, is irrelevant in terms of the generation of economic value for the shareholders.[23] What effectively occurs is a concentration of profits on the shares remaining in circulation, with a benefit that should be exactly the same as the sum which would have been obtained in the case of the distribution of dividends. It should be pointed out that the purchase of own shares is equivalent to the distribution of dividends only in the case of certain expected cash flows; however, if the cash flows are very uncertain, the opportunity of selling the shares to the issuer must be offered to all shareholders, adopting opportune techniques for carrying out such an operation.

2.3. Buybacks and the value creation-distribution choices

For clearly understandable reasons, it can be logically assumed that the management is better informed on the real value of the company than any external shareholders at all times. This asymmetry can lead to situations in which if the share has a price below its intrinsic value, the manager can seek to fill the value gap by informing investors of any "good news" it may have. In practice, through a buyback, the managers can give credible signals of their enthusiasm about future profits by adopting choices which, on closer analysis, restrict the flexibility of the managers themselves. On the contrary, it is less probable that a company which forecasts a reduction in profits will make such a decision, because any distribution to the shareholders could force them to forego remunerative investment opportunities, and it could also place them in a situation of financial stress, because of the minor financial elasticity consequent to a buyback. Therefore, according to the aforementioned theoretical hypothesis – known as the "Signalling Hypothesis" – companies which carry out a buyback will usually have increased profits and cash flows in the future.[24] However, the empirical evidence does not provide unequivocal results. Initial studies on this aspect showed an effective improvement in profits subsequent to buybacks only in fixed price operations.[25] However, this is not the case in open market operations, in which initial research did not uncover any statistically significant cases of increased profits. A later paper, which took into consideration buyback programmes announced between 1980 and 1994, showed a considerable fall in operating profit as a percentage of total investments.[26] The same study also revealed that the analysts forecasts on future profits tend to decrease after the buyback announcements. The results of this study therefore contradict the hypothesis that managers who announce share buyback programmes are providing good news on future profits and cash flows. The other prospective on the reporting hypothesis refers to the undervaluation of the company by the market. In other words, the company thus reports its own disagreement with the market dealing with the assessment of the company. This prospective arises from the consideration that the management is perhaps in a better position to recognise when the market price differs from the company's actual value. It is also consistent with the usual statements according to

[21] See Jagannathan, Stephens and Weisbach (2002); Grullon and Michaely (2002); Lie and Lie (1999).
[22] See Vermaelen (1981).
[23] See Massari (1998).
[24] See Grullon and Ikenberry (2000).
[25] See Dann (1981); Vermaelen (1981); Dann, Masulis and Mayers (1991); Hertzel and Jain (1991); Lie and McConnell (1998); Nohel and Vefa (1998); Allen, Bernardo and Welch (2000); Mitchell *et al*. (2001).
[26] See Grullon and Michaely (2002).

which “the share is undervalued”, is “a good buy”, or “the price does not reflect the company’s real value”, which accompany buyback announcements. But the companies which announce buyback operations do not always actually carry them out. The initial reaction – in terms of increase of stock return - to the announcement of the open market buyback is only 4%, compared to a 15% reaction in the case of a public offer at a fixed price: the 4% reaction would seem a very limited extra yield if the shares to be bought back were actually “a real bargain”! Many companies which announce a buyback, especially with the open market technique, are probably really undervalued; otherwise, one must assume that the market is sceptical in respect of the management’s statements and has a limited reaction to the initial announcement. It is worth pointing out that “market” motivations were at the basis of the buyback programmes to be implemented after listing in the period 1998-2000 by a significant number of newly listed companies, when the IPO operations were being prepared, or immediately after listing. Companies such as CSP, Manuli Rubber, ITR, IRCE, Interpump, Castelgarden, Doria, and IMA announced a buyback plan for the purpose of supporting their securities, and probably also to inform the market of their real value, which was not properly assessed during the listing procedure.[27] Buybacks can therefore also be seen as operations which produce a stabilising effect on the issuer’s shares, and which can thus favour the good performance of future share issues on the part of the company itself. Lastly, buybacks can also have the purpose of favouring the reorganisation of the ownership framework, thus enabling certain shareholders to leave the company – including, for example, merchant banks and closed end funds – and at the same time enabling the distribution of the value created between the entry and exit of the latter.[28]

3. Buyback methods

Buybacks can be carried out in the following ways: open market repurchases, i.e. buybacks on the open market; tender offer repurchases, i.e. public takeover bids; synthetic repurchases, i.e. the issue of transferable put options; target repurchases, i.e. direct purchases from certain shareholder categories.

It is worth noting that in Italy the Civil Code gives the Assembly of Shareholders the power to choose the methods by which a buyback operation must be carried out. Only after the introduction of the Consolidated Finance Act, and specifically art. 132, were indications given in this regard, valid only for listed companies. For the latter, tender offer repurchasing is provided, which companies can derogate at their discretion but in agreement with the company which manages their stock market, rather than the other technical methods listed above. In the open market method, the company announces that it intends to purchase its own shares directly on the market, on the basis of parameters established by the Assembly of Shareholders, such as implementation times, the funds available and the maximum and minimum price at which the transactions will be carried out. The shares are purchased on the market anonymously, through one or more intermediaries.

It can be stated that the announcement of an open market repurchase creates a so-called "exchange option”, which can logically be assessed, enabling the company and the shareholders who do not sell to swap immediate liquidity in exchange for the increase in the market value of their own shares, within the deadline chosen by the management itself. In general, on the various world stock markets, the disclosure level of this operation is reduced.[29] On the Italian stock market, the company is not required to make a public announcement when it makes the purchase, or to obligatorily buy back a given number of shares. In Italy, this technique is the form most commonly used by listed companies for buyback operations, because of the increased flexibility allowed to the management which, after obtaining the approval of the Assembly of Shareholders to repurchase a certain number of shares, has the right to participate in the negotiations for these securities according to the timing and methods deemed most suitable for the achievement of the preset objectives. On the other hand, the main inconvenience of the open market is the market risk, since a possible increase in share prices could lead to an increase in the overall cost of the operation. Furthermore, in the case of this financial manoeuvre, it could take the company a fairly long time to buy a significant number of its own shares, given that open market repurchases depend strictly on the volumes traded daily on the stock market. As already mentioned, the public offer methods of purchase

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[27] See Arosio, Bigelli and Paleari (2000).

[28] This is the case, as will be seen, of the so-called target repurchases.

[29] “*Compared to other corporate activities, one might characterize open market repurchase programs as obscure*”, as stated by Grullon and Ikemberry (2000), page 50. An exception concerning disclosure levels is perhaps represented by the Canadian market, where companies must inform the Authorities which manage the market of the number of shares sold and their price on a daily basis; in this regard, see the interesting research of Ikemberry *at al, op. cit*.

are now fully regulated, following the introduction of the Finance Act, and – as illustrated in the following paragraph – buyback operations must be carried out through a public offer for purchase or exchange unless otherwise agreed. In this case, the offer price and the amount of shares to be purchased are significant elements. This technique enables the full respect of the principle of equal treatment of shareholders, allowing all shareholders to obtain the same information and to pay the same price and, at the same time, to have an equal possibility of selling their own shares. On the other hand, this formula provides less flexibility due to the irrevocable commitment linked to the offer, as well as the difficulty in making use of the best moment at which to buy the shares under the agreed conditions of the public offer. Furthermore, the high management costs, as well as the limited timeframe for carrying out the operation, limit its use exclusively to cases in which the intention is to buy large amounts of shares in a short period of time. In Italy, only four buybacks were carried out through public offers, namely those launched in 1977 by Worthington, in 1982 by Banco di Chiavari, in 1993 by Quaker Chiari & Forti, in 2000 by Telecom Italia on savings shares and in 2001 by Ras. In the first three cases, the buybacks aimed at the constitution of a block of shares to offer in exchange during acquisition operations, while in the case of Telecom Italia, the aim was to withdraw the savings shares. Another alternative buyback method, although not one commonly used in Italy, is the one known as "synthetic repurchase". This approach can vary, depending on whether the company buys call options and/or sells put options on its own shares.[30] This is a fairly singular buyback technique, given that the company which has issued the securities to which the derivative contract refers is a direct counterparty in the transaction. It can be said that the company assumes a dual role; on one hand, it is the contracting party to the derivative contract, whereas on the other, it is the object, being the owner of the product underlying the derivative contract, i.e. its own shares. It is obvious that when the owner of the put option decides to exercise its rights, the company is bound to proceed with a buyback transaction. The disadvantage of this technique thus lies in the fact that the buyback actually takes place solely on the basis of a freely adopted decision on the part of the put owner, which therefore exercises the option when it will be "in the money", which is the case whenever the market value of the shares is lower than the put option price. The last method by which a buyback can be carried out is the above-mentioned target repurchase. In this case, certain well defined categories of shareholders are offered the chance to sell their share packets, in order to simultaneously pursue the objective of reviewing the ownership base.

4. The development of the reference legal framework concerning buybacks on the part of listed companies

Legislation disciplining buybacks has been significantly modified subsequently to the entry into force of Decree Law 58/98 (the Draghi law or Consolidated Financial Act), at least for operations carried out by companies whose shares are listed on regulated markets. Previously, buybacks were disciplined by art. 12, paragraph 1 of Law 149 dated 18 February 1992, which, together with the general legitimacy conditions, contemplated the obligation of carrying out the transaction "on closing call of the stock exchange". In the case of continuous trading through the electronic system, this rule was no longer applicable and a provision was added pursuant to which the purchases had to be made during the continuous negotiating phase (Consob Regulation 10642 dated 16/4/97). This rule, while prescribing the methods and time when the purchase was to be transacted, had the purpose of establishing a mechanism for determining prices which allowed for transparency and verifiability by subjects external to the official market, thus providing greater guarantees regarding possible influences on prices and on equal treatment for all shareholders. The Draghi law introduced another innovation, which was required in order to make the provision more adherent to the new features of the financial markets and respond to an increasingly greater will to protect minorities, thus guaranteeing them the same treatment of the holding company shareholders. In particular, art. 132 of the Draghi law provided that buybacks, carried out according to articles 2357 and 2357-*bis*, paragraph 1 of the Civil Code, had to take place through a public offer of purchase or exchange in compliance with the relevant legislation, or directly on the market in agreement with the market management company, on the basis of methods that could ensure the equal treatment of all shareholders. In the first case, equal treatment is ensured in itself; in the second case, it is pursued by a specific agreement with Borsa Italiana S.p.A., in which the limits and methods of the operation are defined. A similar legal provision is necessary to comply with the principle according to which the transactions must be carried out in a negotiating phase featuring sufficient liquidity to limit its impact on prices and the consequent risk of manipulation. The repurchase of own shares is, in fact, an operation

[30] This method has been used in recent years by many United States companies, together with the implementation of buyback programmes. See Grullon and Ikenberry (2000), page 50.

which in itself could create unequal treatment, as long as the purchasing company could choose only some of the shareholders as its contracting counterparties, and they would be granted the right to sell all or part of their own shares. In order to avoid such disparity, art. 132 rules that buybacks can take place only according to certain negotiating methods, deemed suitable to prevent the inequality inherent to such transactions. This rule is also made more effective by the legislation concerning the concentration of stock exchange transactions. The methods indicated in the provision effectively represent the most suitable instruments to guarantee all shareholders an equal chance of selling their own shares; this is particularly evident in the case of public offers which, by their nature, are addressed under equal conditions to all holders of the financial instruments in question, but it is also a valid principle for open market purchases in which the search for a contractual counterparty and the determination of the price take place on the basis of anonymous mass mechanisms typical of electronic negotiations. Article 132 is also applied when the purchase involves a single category of listed shares, albeit in the presence of several categories of shares. Furthermore, these provisions would also appear to be applicable to the case of a buyback pursuant to a decision for a reduction of capital, to be achieved by the purchase and subsequent void of the shares (pursuant to art. 2357-*bis*, paragraph 1 of the Civil Code). In fact, this is just one of the special cases in which it is necessary to guarantee the equal treatment of shareholders, and therefore requires the application of art. 132 of the Finance Act. [31] The new version of this article, the principle of equal treatment of shareholders always holding firm, grants Consob the power to indicate the methods for the execution of the buyback, compatible with the aforementioned principle. This innovation, on one hand, allows for a more elastic buyback procedure, identifying additional methods of execution to those originally contemplated, possibly standardised with those used in the other European Union countries, and, on the other hand, has regular features aimed at improving shareholders' awareness regarding such transactions by identifying provisions for transparency and the regulation of the approval procedure.[32] In implementation of the power conferred to Consob, operating methods have been identified for buybacks in addition to those already established by article 132 previously in force, and which are, in any case, capable of satisfying the aforementioned needs. In order to ensure the fair treatment contemplated in general by the new art. 132 of the Finance Act, it has therefore been deemed necessary to envisage the conditions concerning three aspects of the buyback programme regarding, respectively, the Assembly of Shareholders decision-making phase authorising the purchase, the type of the operations admitted and market transparency.[33] Deferring detailed analysis of the legal provisions introduced by the Draghi Reform and the relative implementation problems,[34] it is worth underlining that, for the purposes of this work, the legislative text in question represents a considerable breakthrough with the past, since it establishes a clear and precise procedure for buybacks, explicitly aimed at maximum transparency of information and the protection of minority shareholders and, consequently, reduced incentives for speculative behaviour on the part of the companies involved (moral hazard). This provides a significant opportunity for an empirical analysis aimed at assessing the effective impact of the change in legislation

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[31] Another issue regarding listed companies is the case in which the reimbursement of the withdrawing shareholders, carried out by the purchase, on the part of the company itself of the shares held by these shareholders in respect of the limits contemplated by art. 2357 of the Civil Code, necessarily involves the application of art. 132 of the Finance Act. It is maintained that this case does not fall within the scope of application of this provision, since in the context of the exercise of the right of withdrawal, the buyback is only one of the methods for reimbursement, alternative to a reduction in capital, which the company would have to decide upon in the case of the annulment of the reimbursed shares.

[32] In these considerations, it can also be understood that the subject in question regards above all corporate aspects in the strict sense which are not connected to the implementation of the directives on market abuse, aimed instead at ensuring market protection. In this regard, it must nevertheless be observed that Directive 2003/6/EC, concerning buybacks, contemplates specific cases of derogation from the ban on abusive insider trading and market rigging for transactions carried out under conditions established by European Union regulations (EC 2273/2003), adopted pursuant to the same directive. These regulations, in listing the operating conditions for buybacks, prescribe specific methods not only for transactions on the market, but also for those outside the market and for purchases carried out by the purchase/sale of derivative financial instruments. This circumstance introduces the problem of evaluating the limits within which it is possible to enable methods of execution for buyback programmes in Italy, possibly allowed in other European Union countries, which can guarantee equal opportunities to Italian issuers compatibly with the need to respect the principle of the equal treatment of shareholders established by the Finance Act.

[33] In drafting the proposal, the indications expressed in a recent IOSCO document have also been taken into account (see Report on "Stock Repurchase Programs" Technical Committee of the International Organization of Securities Commissions, February 2004.

[34] With specific reference to Onada (2004).

concerning this important type of stock market operation, with particular reference - as described in the paragraph below - to the inquiry method known as "event study".

5. The empirical analysis

The general thesis that the following empirical analysis intends to verify is whether a more favourable environment has been created for the execution of such operations on the part of companies, increasing the range of financial policies available to company managers. More specifically, the research programme to which this work refers hinges on the following hypotheses:

HP 1: Following the legislative amendments, the buyback should become an alternative strategy to the dividends policy and, therefore, there should be an increase in buybacks – and in the relevant announcements – both in absolute and relative value, and in the number of operations.

HP 2: In consideration of the statement of hypothesis 1, an increase will also be expected in the number of companies which decide to adopt remuneration strategies based on buybacks.
HP 3: The reaction of the market to buyback announcements should be positive, at least after the amendment of the reference legislative framework, in both the short and long term.

HP 4: The reaction of the market to buyback announcements should be positively linked to the level of the undervaluation of the companies which announce the buybacks.

Specifically to check the validity of the above hypotheses, the analysis was carried out by dividing the chosen time period into two sub-periods: “pre-Draghi” and “post- Draghi”. This gave empirical evidence of unquestionable significance and consistency. The most important result, apart from the increased dimensions of such operations over time, is the confirmed growth, compared to the pre-reform period, of the positive additional yields subsequent to the buyback announcement. This could be the result of the introduction of provisions which give the market the certainty of equal treatment for all shareholders, aided by the implementation of the provision which contemplates the introduction of the concentration of stock exchange transactions. In the following paragraphs, details of the dataset, procedures and results of the aforementioned empirical analysis are given.

5.1. The sample of companies analysed and the initial empirical results

The starting point of the analysis was the construction of a reference database, since there are currently no public information sources which give records of buyback announcements in an organic manner (as in the case for other similar announcements for that matter) concerning Italian listed companies. Therefore, such announcements were sought by the computerised analysis of the main magazines and newspapers specialised in reporting economic-financial information, through a research algorithm based on key words. The analysis focused on the period January 1990 – December 2003, and generated the largest – and in fact the only – database of its kind concerning the Italian market. The database thus composed included 816 operations which, at present, constitutes a reasonable representation of all the buyback announcements made during the period in question. This sample database was then subjected to a “cleaning" and standardisation process involving the exclusion of announcements for which the economic-financial information on the relevant companies, or detailed information on the operation itself, was incomplete. The final sample was composed of 602 operations over a 13 year period.

The descriptive statistics given in table 2 show that the introduction of the new market regulations have produced certain particularly significant effects, described below, confirming hypotheses 1 and 2 of the research programme.

The average number of buyback announcements for each year increased by 37.4%, from a mean value of 51.4 in 1990 to 70.6 in 2003, suggesting growth in the use of such forms for the distribution of profits to shareholders by managers. The average number of companies which issued buyback announcements increased by 63.9%, reaching the significant number of 46.4 companies, compared to 28.3 previously, again confirming that the strategy has become much more common than it was in the past. It must also be considered that the average figure after the introduction of the Finance Act represents about one third of the total number of listed companies (excluding double listings and direct shareholdings), demonstrating the fact that the phenomenon in question has acquired a dimension that cannot be explained simply by the

growth registered by the Italian stock market during the same period. The average number of companies which announced only one buyback in the two time periods analysed increased from 51.2% to 61.8%. Also taking into due account the size of the sample, this increase is significant and can be interpreted as an indication of the strategic use of buybacks in the case of the undervaluation of a company, rather than an alternative to the distribution of liquidity.

Table 2. Detailed data on buybacks announced by large companies listed on the Italian stock market in the period 1990-2003

Before Draghi reform (Legislative Decree 58/98)						
Year	# buybacks	# companies announcing buybacks	% companies with more than 1 buyback	% companies with more than 2 buybacks	Shares bought back % ordinary shares	% non-ordinary shares
1990	41	23	60,9%	39,1%	68,3%	31,7%
1991	43	25	64,0%	36,0%	74,4%	25,6%
1992	56	24	29,2%	70,8%	71,4%	28,6%
1993	40	25	64,0%	36,0%	70,0%	30,0%
1994	32	19	47,4%	52,6%	65,6%	34,4%
1995	56	26	30,8%	69,2%	69,6%	30,4%
1996	60	32	53,1%	46,9%	81,7%	18,3%
1997	65	39	59,0%	41,0%	70,8%	29,2%
1998	70	42	52,4%	47,6%	80,0%	20,0%
Sub-total (a)	463		-	-	-	-
average	51,4	28,3	51,2%	48,8%	72,4%	27,6%
After Draghi reform (Legislative Decree 58/98)						
1999	77	42	54,8%	45,2%	64,9%	35,1%
2000	82	55	56,4%	43,6%	78,0%	22,0%
2001	61	38	57,9%	42,1%	88,5%	11,5%
2002	66	47	70,2%	29,8%	90,9%	9,1%
2003	67	50	70,0%	30,0%	85,1%	14,9%
Sub-total (b)	353		-	-	-	-
average	70,6	46,4	61,8%	38,2%	81,5%	18,5%
Total (a+b)	816	0				
average	58,3	34,8	55,0%	45,0%	75,7%	24,3%

Source: developed by Authors

The database was further expanded with the economic-financial data of each company at the time of each buyback announcement. More specifically, information was extracted from the Thomson Financial-Datastream concerning ROE, net profits, dividend yield, dimension (total invested capital), financial leverage level, price-to-book ratio and beta for the entire period of the sampling.

The figures in table 3 show that the reform has had an impact not only on the apparent reasons underlying the buyback announcements, but also on the specific features of the companies: the median size of the companies increased from 1.4 billion Euros during the first sub-period (1990-1998) to 2.5 during the second (1999-2003). The surge in terms of income ratios, such as the ROE and the P/BV, are even more significant, apparently indicating an increase in the intrinsic value of the companies which then announce a buyback, thus confirming the undervaluation hypothesis. This is confirmed by the intrinsic risk assessment measured in terms of beta for the individual companies, for which no significant reduction occurred with the change in legislation and the increase in buybacks. In other words, for each given risk level, the companies which have announced buybacks seem to have improved their own income situation. On the other hand, an apparently different indication is given by the reduction in the Dividend Yield rates, possibly confirming the hypothesis of replacement (hypotheses 1 and 2), or the use of the buyback as a form for the distribution of liquidity alternative to the dividend method.

5.2. Analysis through event study

As mentioned above, to study the impact of the buybacks on the value of companies listed on the Italian stock market, the tried and tested "event study" method was used (Fama *et al.*, 1969; Campbell, Lo and MacKinlay, 1997; Ikenberry, Lakonishok and Vermaelen, 1995 and 2000; Loughran and Ritter, 1995; Mitchell and Stafford, 1997). In particular, anomalous returns (AR) on “n” shares, which represented the selected sample, were calculated and, according to that dictated by the financial theory on asset pricing models, the standard regression was calculated on the basis of the following equation:

$$ar_{i,t} = c_{i,t} + b_{i,t} \times mr_{m,t} + ee_{i,t}$$

where:

$ar_{i,t}$ = the return of the ith security in the period t;

$c_{i,t}$ = the regression coefficient, which estimates the level of the guaranteed minimum return in the case of zero risk on the ith security;

$b_{i,t}$ = regression coefficient, giving a measure of the sensitivity of the return of the ith share in respect of the market return in the period t;

$mr_{m,t}$ = market return in the period t;

$ee_{i,t}$ = estimation error.

Table 3. Market and accounting figures of the sample companies

	Dividend Yield	Net profit	Total assets	Leverage	ROE (%)	P/BV (%)	Beta (%)
Before Draghi reform (Lgs. Decree 58/98)							
Median	3,45	119.890,20	11.425.331,22	27,76	1,48	1,80	0,80
Standard deviation	5,16	312.389,76	22.567.925,55	23,37	8,86	2,56	0,30
Median	2,22	21.920,00	1.462.970,00	23,35	1,01	1,21	0,81
Mean first quartile	3,80	73.663,30	7.960.485,00	43,58	2,36	1,88	1,03
Mean last quartile	1,23	4.556,05	471.746,00	6,37	0,34	0,75	0,60
After Draghi reform (Lgs. Decree 58/98)							
Median	2,85	197.157,50	24.155.098,81	31,00	2,96	2,06	0,79
Standard deviation	3,99	1.057.241,23	48.531.662,55	26,29	12,77	2,31	0,33
Median	2,09	22.395,00	2.468.019,00	25,97	1,52	1,38	0,78
Mean first quartile	3,66	127.692,00	20.439.025,51	53,69	4,42	2,23	0,98
Mean last quartile	1,19	3.842,00	574.202,50	5,02	0,41	1,05	0,55

Source: developed by Authors on Thomson Financial Datastream data

Following the paper of Elton and Gruber (1995), were calculated the abnormal returns (Abnormal Returns, or AR), represented by the difference between the returns observed *ex-post* and those foreseen *ex-ante* on the basis of the standard regression indicated above. After calculating the abnormal returns, were estimated the accumulated abnormal returns (Cumulative Abnormal Returns, or CAR), applying the known Fama ratio,[35] on the basis of two different timeframes: the first, for a period of 5 days, from the 3rd day prior to the 2nd day after the announcement, and the second for a duration of 120 days, from the 3rd day prior to the 117th day after the announcement. After calculating the Cumulative Abnormal Returns for the two periods of 5 and 120 days respectively, the standard statistical tests were applied to check the plausibility of the results; the results were then analysed together with the main economic and financial indicators calculated from the financial statements of the companies in the sample analysed. It must be noted that the analysis of the cumulative data for specific periods helps to examine the phenomenon being investigated more accurately, isolating the effects on the share trends registered during various time intervals. More specifically, the observation of the CARs in the period preceding the event enables the assessment of the extent to which the investors have been able to foresee the operation and, if necessary, to ascertain the existence of insider trading. The study of abnormal returns within a limited period of time during which the transaction takes place (the so-called *Announcement to Date Abnormal Returns* or AAR), enables the assessment of not only the dimension of the impact but also the speed of the price adjustment consequent to the new information. This process, in the case of an efficient market, must be extremely fast without allowing for the possibility of gaining extra profit by opportune arbitration. Lastly, the analysis of the CAR in the period following the event has the specific purpose of confirming whether the reaction to the trend persists or not and whether there is a time delay in the adjustment of the prices to the new information available.

5.3. The results of the event study analysis: the reasons for the announcements

The first aspect examined through empirical analysis concerns the reasons for the buyback announcements to the market, in order to ascertain which of the various theoretical lines previously

[35] See Fama *et al.* (1969).

examined offers an explanation which can give a better interpretation of Italian companies. In this regard, the data emerging from the analysis shows that, before the introduction of the capital market reform, the effect of the announcement, measured by the abnormal returns, is not far removed from zero (see figure 1 and table 4). However, taking into consideration the 5-day period within which the buyback announcement is made, a cumulative abnormal return of about 1% is found, while the same parameter is negative if calculated for the 120-day period. In practice it appears, on one hand, that the market reacts immediately - and positively - to the buyback announcement but, on the other hand, that the announcement is associated with a future negative performance - albeit not in the very immediate future - witnessed by a relevant and negative cumulative abnormal return in the long term (-2.331%). Conversely, after the capital market report, there is a deep change in the situation, not in terms of abnormal return consequent to the announcement, which shows substantially the same averages and variability as the pre-reform values, but in terms of cumulative abnormal returns: the companies which announced buyback operations after the reform show a positive cumulative return amounting, on average, to 2.5%, over a time period of 120 days, thus also supporting hypothesis 3. To be precise, it may be noted that after the Draghi Report, buybacks have assumed major significance in the financial policies of listed companies. The number of companies which make use of this possibility has increased and there is a corresponding decrease in the number of announcements per company. For this reason, the phenomenon concerns the larger companies more than in the past, as shown by the table (4) of the total invested capital of the sample companies.

Table 4. Reaction of the Italian stock market to buybacks in the period 2000-2003: abnormal returns (AR) and cumulative abnormal returns (CAR)

Before Draghi reform (Legislative Decree 58/98)										
Year	*# buybacks*	*# companies announcing buybacks*	*Dimension (tot assets)*	*Beta*	*AR*	*Std. Dev.*	*CAR 5 days*	*Std. Dev.*	*CAR 120 days*	*Std. Dev.*
1990	20	13	€ 62.384.321	0,98	-0,077%	1,75%	0,458%	3,11%	4,525%	16,49%
1991	29	21	€ 101.427.381	1,07	-0,496%	2,25%	0,099%	3,68%	-5,661%	23,96%
1992	33	20	€ 92.535.067	1,00	0,561%	2,00%	1,199%	4,80%	-13,671%	22,08%
1993	28	21	€ 261.877.890	0,79	0,086%	2,12%	-0,645%	5,12%	-1,180%	23,12%
1994	22	16	€ 36.962.279	0,61	1,037%	1,18%	2,621%	5,61%	-1,303%	17,34%
1995	38	25	€ 391.912.662	0,71	-0,202%	2,10%	0,032%	5,24%	3,226%	22,40%
1996	39	26	€ 500.445.388	0,70	0,522%	2,77%	3,926%	12,06%	6,210%	20,83%
1997	55	37	€ 537.719.721	0,70	0,366%	2,55%	0,948%	5,32%	3,739%	20,62%
1998	51	37	€ 496.248.409	0,69	-1,249%	2,76%	0,514%	7,11%	-14,081%	23,91%
Sub-total (a)	315	216	€ 2.481.513.120	-	-		-	-	-	-
average	35,0	24,0	€ 275.723.680	0,74	-0,010%	2,40%	1,028%	6,63%	-2,331%	22,77%
After Draghi reform (Legislative Decree 58/98)										
1999	65	40	€ 491.696.071	1,03	0,738%	3,03%	1,171%	6,96%	0,141%	28,71%
2000	65	51	€ 753.615.357	0,79	1,052%	2,66%	1,117%	6,04%	10,591%	25,07%
2001	46	36	€ 419.366.783	0,73	0,799%	6,99%	-1,233%	15,35%	-5,707%	34,73%
2002	53	44	€ 459.441.251	0,89	-0,455%	1,99%	1,294%	5,09%	-4,121%	30,65%
2003	58	45	€ 472.008.770	0,92	-0,164%	3,07%	-1,159%	12,08%	2,396%	31,18%
Sub-total (b)	287	216	€ 2.596.128.232	-	-		-	-	-	-
average	57,4	43,2	€ 519.225.646	0,87	0,416%	3,78%	0,326%	9,55%	2,543%	30,21%
Total (a+b)	602	432	€ 5.077.641.352	-	-		-	-	-	-
average	43,0	30,9	€ 362.688.668	0,81	0,193%	3,14%	0,693%	8,16%	-0,629%	26,62%

Source: developed by Authors

Going on to analyse the main business fundamentals of the companies that have announced buybacks before and after the reform, and taking as reference in particular the figure of the trend of the Dividend Yield quotient, which registers a negative trend for both the ROE and the Price to Book Value ratio (B/BV), the undervaluation hypothesis (hypothesis 4) seems to be confirmed. For companies whose securities are undervalued, and whose market prices therefore do not include the respective intrinsic value, a buyback creates value for the shareholders, maintaining the company's buyback strategy unaltered (see table 5).[36] However, the liquidity is distributed to the shareholders in the form of dividends only if there is no undervaluation by the market.

[36] It must be noted that the data in table 5 – and in table 4 - represent average annual values, calculated with reference to the sample companies which have announced buyback operations during a specific year. This generates an undoubted lack of uniformity which must induce caution when comparing the data for the different periods, since the companies announcing buybacks are not the same from one year to another. However, this framework is important for reasoning at an aggregate level and for examining the systematic impact of the Draghi Reform on the financial

Table 5. Market yield and accounting ratios of companies listed on the Italian stock market which announced buybacks in the period 1990-2003

Year Anno	# buybacks	# companies announcing buybacks	CAR 120 (120 days)	Std. Dev.	Dividend Yield	Std. Dev.	ROE	Std. Dev.	P/BV	Std. Dev.
Before Draghi reform (Legislative Decree 58/98)										
1990	20	13	4,525%	16,49%	5,51%	9,04%	1,84%	11,94%	2,06	1,06%
1991	29	21	-5,661%	23,96%	4,31%	4,18%	3,31%	6,14%	1,19	0,51%
1992	33	20	-13,671%	22,08%	4,71%	2,02%	1,76%	2,50%	0,73	0,38%
1993	28	21	-1,180%	23,12%	3,99%	2,80%	-0,85%	8,08%	0,97	0,49%
1994	22	16	-1,303%	17,34%	1,35%	1,18%	-3,10%	16,53%	1,17	0,45%
1995	38	25	3,226%	22,40%	1,92%	2,09%	2,18%	5,05%	1,38	1,13%
1996	39	26	6,210%	20,83%	4,03%	8,24%	3,58%	6,07%	1,89	2,24%
1997	55	37	3,739%	20,62%	3,94%	6,96%	0,03%	10,65%	1,78	2,41%
1998	51	37	-14,081%	23,91%	2,09%	1,07%	2,45%	9,60%	3,62	4,80%
Average (a)	35,0	24,0	-2,331%	22,77%	3,45%	5,17%	1,48%	8,88%	1,80	2,56%
After Draghi reform (Legislative Decree 58/98)										
1999	65	40	0,141%	28,71%	1,99%	1,06%	3,17%	3,06%	2,31	2,65%
2000	65	51	10,591%	25,07%	3,31%	5,27%	6,54%	17,45%	2,67	3,34%
2001	46	36	-5,707%	34,73%	2,32%	2,34%	2,76%	15,82%	2,31	2,18%
2002	53	44	-4,121%	30,65%	2,75%	2,13%	-0,42%	14,85%	1,39	0,85%
2003	58	45	2,396%	31,18%	3,88%	6,18%	2,08%	6,73%	1,51	0,87%
Average (b)	57,4	43,2	2,543%	30,21%	2,85%	4,00%	2,96%	12,79%	2,06	2,32%
Total average (a + b)	**43,0**	**30,9**	**-0,629%**	**26,62%**	**3,16%**	**4,65%**	**2,18%**	**10,91%**	**1,93**	**2,45%**

Source: developed by Authors

Table 5 also shows that buybacks are increasingly used as a remuneration strategy alternative to the dividend method. During the period 1999-2003, the sample companies, on one hand, have had better average performance levels (the mean ROE has more or less doubled compared to the period 1990-1998 and the P/BV quotient has increased by almost 15%) while, on the other hand, they have distributed value mainly due to the effect of the share price trend consequent to the buyback announcements, rather than by the distribution of dividends, as shown by the reduction of over 17% in the Dividend Yield quotient.

6. Conclusions and developments for future research

In this work we tried to investigate the determinants of stock repurchases' announcements declared by Italian companies listed on the equity capital market, in order to empirically test the validity of the hypothesis proposed by academic literature to explain such a phenomenon.
To enter into details, the main purpose of the article was to investigate which theories can best explain the sharp increase in buybacks announced by companies listed on the Italian stock exchange over the last decade. One major reason explaining the originality of our contributions lies behind the specificity of the Italian context, owed to the existence of a significant "legislative discontinuity" taking place in 1998 thanks to the introduction of the reform of the financial markets which, among other provisions, taxed dividends and capital gains in the same way, and which also introduced new and more severe criteria concerning corporate governance and transparency – also in the case of buyback operations – in the obligatory financial reporting produced by the companies. For these reasons, an original dataset was created, allowing to carry on an empirical analysis, aimed at checking the main theories for the explanation of buyback decisions. The results obtained clearly indicated, firstly, a significant evidence in favor of the undervaluation hypothesis which, we would recall, interprets the buyback decision as an indication of stock undervaluation. Secondly, evidence also emerged in support of the replacement hypothesis, which interprets buybacks as a strategy for remunerating shareholders as an alternative to the distribution of dividends, with the advantage of maintaining the company's standard dividend policy unaltered. This is also shown by the fact that, in situations of positive average performance – and increased one compared to that emerging in the pre-Draghi reform – the dividend distribution rate decreased considerably after the introduction of the reform. Lastly, it seems clear that after the innovation in execution procedures introduced by the Consolidated Finance Act, the share repurchase has become an effective decision-making lever for the management of Italian companies, with the capacity, regardless of the specific underlying reasons, to achieve significant effects on the trends of the price of listed shares. This is shown by the fact that the volume and frequency of the buyback operations has increased considerably since 1999, as has the number of companies which have used this instrument. Unfortunately,

policy choices of companies listed on the Italian stock market.

because of the structure of the financial report of companies on the Italian market, it is not possible to include in the dataset information on the effective buybacks subsequent to the announcements. Similarly, it was not possible to cross-check this data with share performance in the long term, in order to further support the results emerged from this empirical analysis.

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PERFORMANCE MANAGEMENT AND THE BALANCED SCORECARD IN THE MODERN NON-PROFIT ORGANISATION

*Ian O'Boyle**

Abstract

Performance management is a process that has been used in the for-profit business environment for many years and has had significant benefit for that sector. As the not for- profit organisation enters new dimensions of competitiveness, increased professionalism and a call for greater transparency, the utility of a performance management approach within the not for-profit environment and its potential benefit for such an organisation is explored. The application and appropriateness of the balanced scorecard as a measurement tool is analyzed within the article and it becomes apparent that such a tool can have a direct impact on the performance of the modern not for-profit entity.

Keywords: Performance Management, Non-Profit Organisation, Scorecard

**Lecturer, College of Sciences, Massey University, Palmerston North, New Zealand*

1. Challenges facing the Modern Non-Profit Organisation (NPO)

The modern non-profit organisation's administration and daily running requires increasingly specific industrial knowledge. To sustain the existence of their non-profit status, managers must be equipped with the necessary skills to lead these organisations into the future and a more professional approach must be adopted particularly at management levels. Managers must familiarise themselves with the various management techniques required to perform well within the modern environment, which often requires adaptation of existing techniques applied in traditional businesses practices.

NPOs have evolved to encompass a role in education, healthcare, economic development, the labour market and various social issues. The way in which these organisations are managed, is therefore required to differ from traditional organisational management. The principles, methods and conditions that exist within NPOs must be analysed before senior management decide on the best style and form of management which suits their organisation. Management must ultimately address two key issues when establishing their future management principles and practices: the nature of the performance that the organisation seeks to achieve; and how this performance is going to be driven.

The modern NPO is being confronted with an operating environment that has seen substantial change relating to competitiveness and professionalization. As a result, many organisations have progressed from simply an administrative function to adopting a marketing, on-going strategic and performance approach. Chappelet and Bayle (2005) argue this strategic and performance management style of management is crucial for organisations to define projects, to structure them in a way that will allow them to achieve success, and most importantly to evaluate the project once it is completed in order to draw useful conclusions for the continuation of the project or the establishment of new ones (Chappelet & Bayle, 2005).

It is an obvious fact that organisations must clearly define strategic plans and objectives before any performance management system can be put in place. Management itself can be considered as a cyclical process consisting of sub processes that interrelate with each other on a number of different levels (Fischer & Otswald, 2005). In essence, performance management will be impacted directly depending on the strategic direction and objectives operating within a NPO.

Strategic and performance management are most commonly applied in the traditional business setting, but can also provide significant benefit to many other institutions such as schools, churches, community meetings, health setting, governmental agencies, political settings and sports organisations (Diaz-Martin et al, 2000) as these principles are needed whenever such organisations interact with their environments to produce desired effects.

NPOs are predominantly concerned with the effective delivery of their mission. Potentially they may end up earning a profit at year end, but these extra finances must be reinvested within the organisation in order for it to retain its non-profit status. NPOs can be compared with traditional business through comparing the members and stakeholders of the organisation to clients and shareholders of a traditional business institution. NPOs can take the form of associations, foundations, cooperatives, trusts, societies and even corporations and companies (Kotler & Andreasen, 1991, p. 10).

2. NPO Strategic Management

Although the private sector did not fully adopt the concept of strategic planning during the 1990's, the public sector and particularly non-profit organisations did see the use in creating strategic plans for their organisations and were more receptive to this new and emerging initiative. Nutt and Beckoff (1992) stress "the importance of strategy in the public and non-profit sectors" due to "turbulent conditions that were forcing change" (Nutt & Beckoff, 1992, pp. 1-2). Joyce states "the formal system of strategic management in the public sector has emerged.... and is based on strategic planning principles" (Joyce, 2000, p.3). Crozier (1991) concurs that within the public sector "a reform can only develop based on the vision of a different future and by affirming some strong directions," hence by "drawing up a strategy, a choice of priorities depending upon reasonable reflection regarding resources, constraints and objectives". Before the 1990's, the term strategy was absent from the language of management within NPOs, and if these entities wished to succeed in an increasingly competitive environment, they could no longer ignore the concept of strategic management in order to adapt to the evolution of the NPO sector (Ramanantsoa & Thiery – Basle, 1989, p. 23).

The majority of literature relating to this issue has the common theme running through it that strategic management in NPOs differs from that in the commercial sector (Nutt & Beckoff, 1992, p. 22). It is argued that a primary cause of the difference between these two sectors is that NPOs have a much higher degree of public responsibility in contrast to traditional commercial organisations. An example of this occurred in 1999 when the International Olympic Committee was involved in a bribe scandal and a huge amount of public interest was generated throughout the world. It could be argued that a similar scandal within a private company would not have generated the same amount of public scrutiny and media attention (Bozeman, 1987). Due to the impact that NPOs can have on the general public, it is imperative that the issues of accountability and legitimacy are high on the agenda of senior management. NPOs must exercise concern regarding their many stakeholders while traditional businesses can place clients and shareholders as their highest priority, since their main goal is to achieve profits. NPOs must also operate with a satisfactory degree of efficiency, effectiveness and performance in relation to its various stakeholders. These organisations have a vision that is often an ideal and may possibly never be realised: they can have a political dimension and it may often be difficult to judge the success or failure of an implemented strategy. A large amount of volunteerism exists within the non-profit sector, and elected officials often form part of this, who in principle, decide on the strategy to be followed. "Their motivations and opinions may be different from those of the salaried managers who are responsible for carrying out the strategy but who often also draw it up" (Chapelet & Bayle, 2005).

Even though there are clear differences in strategic management of these two types of organisations, it does not necessarily prevent the application of the concepts and tools of strategic management to NPOs in general on a local, regional and even national level. It does however require an intelligent management team, who can take the major differences into account and ensure that the application of these practices would not be counterproductive to the overall objectives of the organisation.

3. NPO Performance Management

Little research has been carried out examining how NPOs view the issue of performance management and if they use models such as The Performance Prism (Neely, 2002), Balanced Scorecard (Kaplan & Norton, 1996) or EFQM model (Wongrassamee, Simmons and Gardinerin, 2003) in order to assist them in

achieving their strategic goals and manage performance effectively. These models have been proven to be successful in the traditional business environment and given that many NPOs have much in common with the business industry, it is imperative research be carried out to critically examine this issue in greater detail.

A NPO can be described as an organisation, whose main goal is not financial returns, rather the performance of their mission (Chappelet and Bayle, 2005). This is why the issue of performance management is of critical importance for such entities, perhaps even more so than organisations operating within a traditional business environment. Many commentators (Mahony and Howard, 2001; Miller, 1997) on NPOs suggest that management involved in this industry are limited by their ability to transfer knowledge of conceptual business practices to the non-profit environment. One of the greatest challenges for NPOs is to ensure that their current and future managers have the necessary skills to lead their organisations in the twenty-first century (Chappelet and Bayle, 2005). Managers within these organisations must familiarise themselves with performance management techniques and adapt them to this unique sector of the management world.

Before any performance management system can be applied within a NPO, senior management must fully adopt principles that are based on improving overall organisational performance (Bond, 1999). They must be seen to endorse the new system at all levels within the organisation along with ensuring a consistent relationship with other preexisting initiatives operating within the organisation, such as cross functional integration and focus on the accountability of teams rather than individuals operating within the organisation. Lyons (2006) claims an organisation must focus on its strategies and vision as appose to the daily internal operations of the organisation. Strategic objectives must be directed by management to ensure that all employees are aware of how their own job description fits in with the strategies and performance goals of the organisation. He goes on to claim that teams themselves are the owners of the performance management system and are accountable for all aspects of that system. Management should allow teams dictate which measures will assist them in the implementation of their roles most effectively. Management must not assume that they are aware what is best for the teams as they will have removed ownership of the system and returned to a command and control style of management, leaving employees powerless (Moffat, 2000).

An integral part of the performance management system within both traditional and non-profit entities is to set various targets. Performance targeting (Walsh, 2000) has the ability to make positive contributions to any management system. It is important that organisations make proper use of performance targets as this technique has a number of limitations and if not implemented properly can have adverse effects on performance. Research has shown that if targeting processes are not carefully designed and implemented, employees can become solely focused on the targets themselves and lose sight of the long term objectives and aims of the organisation (Walsh, 2000; Hood, 2003). This has proven to be one of the major pitfalls when establishing performance targets. In NPOs and many other public sector entities performance pitfalls can be viewed as of a critical importance due to the special conditions related to responsibility and accountability in the public sector as opposed to the private (Schacter, 2002).

Walsh (2000) argues performance targets are created in order to place attention on particular processes and outcomes relating to a given organisation and also to align the behaviour and actions of individuals to the overall goals and objectives of the organisation, along with the expectations of stakeholders. The case often arises where unintended consequences related to performance targets become adverse to the overall performance of the organisation, requiring constant monitoring and review of this process (Van de Walle & Roberts, 2008). The most prominent example of this, as stated above, occurs when individuals become solely focused on targets that are set out for them and lose sight of the overall mission of the NPO (Maleyeff, 2003).

4. Measurement: The Balanced Scorecard

Kaplan and Norton (1992) developed this performance management model that has been used as an effective strategic planning and management tool throughout many organisations and across vast amounts of industries. It has provided senior management with an effective way of monitoring actions and processes undertaken by employees and allowed them keep record of these actions and consequences in an efficient manner. Although initially only adopted in mostly western countries, it has now spread throughout the global business environment and has been integrated in many non-English speaking

nations. Since 2000, use of the Balanced Scorecard and its derivatives such as the Performance Prism (Neely, 2002), and other similar approaches to management, including Results Based Management have become common in organisations throughout the world. Kurtzman (1997) produced research declaring that almost 70% of companies' responding to a questionnaire were measuring performance in a way that was extremely similar to that of the Balanced Scorecard. This method of performance management has been implemented by traditional business and corporations, some government agencies and a hand full of other non-profit organisations. With the increasing parallels between the for-profit and non-profit sectors, it is time for this tool to be implemented across the broader spectrum of the NPO sector.

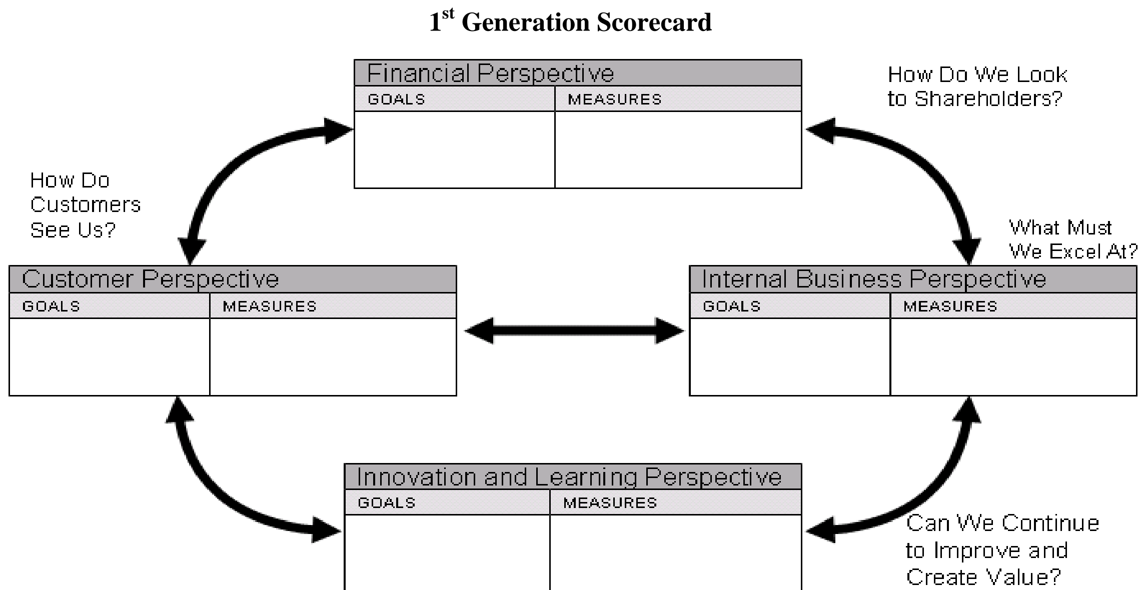
Standardised Balanced Scorecards are relatively easy to implement and can have a positive impact on a NPO. However, using one organisation's Balanced Scorecard and attempting to apply it to another organisation can be very difficult and research has suggested that one of the major benefits of the Scorecard lies within the design process itself (Kurtzman, 1997). Problems can arise if the Balanced Scorecard is designed by consultants who may not have had specific knowledge of operations within the organisation.

The unique aspect of the Balanced Scorecard which was a new development in the measurement initiatives adopted by for-profit organisations is that it combined financial and non-financial aspects of organisations to give a more detailed view of how the organisation was really performing within its operating environment. In addition, utility and clarity were further enhanced as Kaplan and Norton suggested measures within an organisation should be condensed and grouped together so they could be easily displayed within a four box model (Kaplan & Norton, 1992, 1993). Aside from this new approach to measurement within an organisation, the original definitions of the Balanced Scorecard model were sparse. From its initial inception however, it became clear that selection of measures, both relating to the filtering and clustering process would prove themselves to be the integral activities that management should address in the implementation of this tool. The measures that were to be selected, according to Kaplan and Norton (1992), should be synonymous with issues and initiatives that were relevant within the organisations strategic plans and a simple process of requiring information concerning attitudinal issues would aid in determining which measures should be associated with each perspective (Kaplan and Norton, 1992).

A major issue that became apparent after Kaplan and Norton's initial book, 'The Balanced Scorecard' (Kaplan & Norton, 1996) was that the model did not address the managerial issue of the development of long-term sustainable strategies. Following on from this publication, a second book 'The Strategy Focused Organisation' (Kaplan & Norton, 2000) echoed research previously conducted in this area (Olve & Wetter, 1999) relating to the visual documentation of the links associated with measurement and the development of the 'Strategy Map' (Kaplan & Norton, 2000). This important development within the model inspired a number of very similar variants, improved the model's utility and propelled it into mainstream industries that saw the value in adopting such a performance measurement technique. Modern versions of the Balanced Scorecard can be closely associated with this type of model and the initial samples of the model have become mostly redundant. Modern Balanced Scorecards have also evolved to be more flexible and 'user friendly' and can be applied to almost every type of organisation both in the for-profit and not-for-profit sectors.

Kaplan and Norton's (1992) initial design was laid out as a simple 'four box' model that could help organisations ensure they were getting the best results out of all the resources available to them (Kaplan and Norton, 1992). The model suggested that financial measures should not be the only perspective to be analysed. They proposed three other perspectives along with the traditional financial perspective. Learning and Growth; Internal Business Process; and Customer, were also chosen to represent the major stakeholders within an organisation (Mooraj et al, 1999). Research surrounding Balanced Scorecards is vast and some authors have suggested the renaming of these perspectives along with the addition of new perspectives within the model. These arguments have become apparent as a result of recognition that dissimilar but equivalent perspectives would potentially result in a different set of measures. A crucial element of the adoption of this model is that users have confidence that the aspects chosen to be measured are relevant otherwise results can be regarded as insignificant. This has been the predominant factor in 1st generation balanced scorecards becoming redundant as earlier stated (Olve et al, 1999, Kaplan and Norton, 2000, Niven, 2006).

1st Generation Scorecard



(Cobbold &Lawrie, 2002)

Despite its huge popularity as a concept, literature relating to the design of the 1st generation Balanced Scorecards is sparse. The seldom pieces of literature that do concentrate on the application of the 1st generation Balanced Scorecards (Butler et al, 1997) and related organisational experiences (Ahn, 2001) generally support the model but also detail the weaknesses in the initial design phase of the approach and suggest improvements that eventually become incorporated in future Balanced Scorecard designs (Epstein et al, 1997; Eagleson et al, 2000; Kennerley et al, 2000).

Since its initial inception in the early 1990's, many variants and alternatives of the Balanced Scorecard's 'four box' approach have become popular throughout the performance management sector. Many of these variants serve little purpose and have little utility. They are often proposed by those within academia in order to propel other agendas such as green issues (Brignall, 2002) or private consultants who develop similar models in order to increase profits from book sales or conference appearances (Bourne, Franco & Wilkes, 2003). Many of these related models are unquestionably similar and research (Cobbold & Lawrie, 2002) has attempted to establish a pattern in these similarities noting three distinct types of variations. These models can be grouped into 'generations' as part of the evolving process of this performance measurement model (Cobbold & Lawrie, 2002). The original Kaplan and Norton design along with other models who propose the simplistic 'four box' approach are often classed as the 1st generation Balanced Scorecard. The emergence of the 'strategy map' coincided with this original design such as the Performance Prism (Nelly, 2002) and the Performance Driver model (Olve & Wetter, 1999) constitutes 2nd generation Balanced Scorecards and more modern designs which incorporate a paragraph relating to the long-term vision of the organisation called 'destination statements' within the model have now become known as 3rd generation Balanced Scorecard models (Cobbold & Lawrie, 2002).

5. 2nd Generation Scorecard

One of the major criticisms of the 'first generation' Balanced Scorecards was that it seemed like a solid idea in theory put when put into practice, a number of difficulties would arise resulting in many practitioners scrapping the model due to its lack of utility and vagueness. Throughout the 1990's, new design methods began to emerge, some from Kaplan and Norton themselves and others from independent consultants with similar theories and thought processes. These new designs incorporated the 'strategy map' which consisted of a set of objectives strategically placed within the model in order to further assist the organization in maintaining focus of the organization long-term visions. Under this new design method, Balanced Scorecards now began to associate strategic aims alongside the pre-existing four perspectives and as a result were able to 'connect the dots' by visual means of the objectives of the organization and the aspects of the organization that were to be measured as part of this new initiative.

Kaplan and Norton (1992) argued that for an organization to be successful financially, they must analyse the ways in which they appear to their shareholders. 2nd generation scorecards did not adopt this synopsis, and instead created a process of associating a limited amount of performance measures to be placed alongside each perspective within the model. Strategic objectives now became a key priority within the model and were used in order to capture the essence of the organization's strategic operations associated with each performance aspect. The aspects of the organization that were to be measured were then carefully selected in order to ensure they coincided with these prioritised strategic objectives (Kaplan & Norton, 1993). Although initially not considered as a major redesigned of the pre-existing model, strategic objectives proved to be an integral readjustment to the Balanced Scorecard as these objectives were know directly derived from the organization strategic plans. The 'strategy map' element of the revised model comes about as management select the aspects of the organization they feel are of most importance to measure, then the 'cause-effect' relationship between these aims can be defined through the establishment of links between them. The model can then be derived to measure the strategic performance of an organization by combing, strategic objectives, the selected measures and the visual assistance of the 'strategy map'. This innovation within the Balanced Scorecard model allows management greater ease of use and provides justification for choosing the selected measures.

These changes in the design and evolution of the Balanced Scorecard were recorded in Kaplan and Norton's (1996) book 'The Strategy Focused Organisation'. They claimed that the balanced Scorecard model had now evolved from a simple performance management tool to a core aspect that should be applied within all organizations (Kaplan & Norton, 1996). Coinciding with their beliefs that the Balanced Scorecard can help an organization with the implementation of strategic objectives, Kaplan and Norton argued that this model should be at the core of all strategic and performance management activities within an organization (Kaplan & Norton, 1996).

From 1996 onwards, 2nd generation Balanced Scorecards became popular throughout all sectors and industries and established itself as the leading performance measurement tool an organization could avail of. A number of criticisms are still apparent with these 2nd generation Balanced Scorecards but they have proved through practical application that they are still more successful when compared with the original Kaplan and Norton models.

6. 3rd Generation Scorecard

Just before the beginning of the millennium, evolution of the Balanced Scorecard began to occur once again. This resulted in order to address the deficiencies incorporated within the '2nd generation scorecard' designs which failed to acknowledge that opportunities to intervene in the strategic process must be made available in order to anchor objectives in the 'present', real and current management operations. Another major weakness of the '2nd generation designs' is that they ignored the need to 'roll forward' and assess the impact that strategic objectives would have on the organisation. As a result a further element was added into the mix within the Balanced Scorecard design known as the 'Destination Statement'. This instrument consisted of little more than a brief paragraph of what the 'strategic success' or 'end-date' of the strategic plans would look like. Initial 'destination statements' were constructed with a particular time-line associated with them (e.g. in four years' time) detailing which objectives needed to be achieved in this amount of time. Through the application of this new instrument, organizations could know assess how targets were being met on an annual basis and if the strategic vision of the organisation was on its way to being achieved. Management quickly began to understand that if a 'destination statement' was to be incorporated within a Balanced Scorecard model, the selection of strategic objectives and measurement of strategic operations would become an easier exercise for the organisation by allocating targets and measures that could be easily selected to view and track the progress of strategy.

Organisations quickly began to realise that through the implementation of a 'destination statement' senior management and individuals within the workplace were now able to relate their roles directly to the 'destination statement' without constantly making reference to strategic goals that have been set out by the organisation. As a result of this revelation, the design approach of the model was 'reversed' with 'destination statements' attracting the initial attention of the designers as opposed to the final element of the design phase. It was further uncovered through its practical application that establishing a 'destination statement' first, made the selection of strategic objectives and consensus of management and teams within the organisation more efficient.

For an NPO to have the ability to make rational decisions relating to its operations and to set targets for strategic objectives, it must develop and be able to articulate exactly what the organisation is aiming to achieve (Senge 1990, Kotter 1995). Through the application of a 'destination statement' a NPO can detail how exactly it will look within an agreed-upon future time scale (Olve et al, 1999; Shulver et al, 2000). This instrument often builds upon some existing strategic plans or documents, but it is seldom in practice to find a pre-existing document that can offer the certainty and clarity needed in order to aid a NPO in the performance of its strategic objectives.

7. Conclusions

As the modern NPO continues to evolve in relation to professionalism, accountability and transparency, it is crucial that the management of these organisations realize the importance of implementing an adequate performance management system throughout the organisation. The gap of industrial knowledge between the for-profit and not for profit sector appears to slowly be beginning to close, however management within NPOs must continue to familiarize themselves with best practice of successful systems and business initiatives within the traditional business environment. This knowledge is almost completely transferable to the NPO sector and will increase the strategic, performance and overall organizational success of these unique entities.

Looking forward, it is imperative that the Balanced Scorecard will be a model that is synonymous with performance management in NPOs, and management within this sector must stay up to date with the inevitably of further evolution of the current models. Strategy Maps have been proven to be successful in practical applications and these instruments along with 'destination statements' should be used in concurrence with the adoption of the Balanced Scorecard model in the not for profit sector. NPOs should follow the other organisations that have begun to use the Balanced Scorecard in order to guide and monitor the performance of their strategies and assist supervisory boards in strategic decision making. It is important that the measurement of data required in order to satisfy demands of the model can be done efficiently and annual reports within a NPO should begin to focus more on the application and results of the organisation in relation to the effective utility of the Balanced Scorecard. NPOs must accept that information technology and Balanced Scorecard software are now playing key roles in the operations of all modern day organisations and understand the importance of adopting a performance management culture, which is being reinforced throughout all industries as its importance begins to be fully realised.

The theory surrounding management control and the practical applications of the Balanced Scorecard have begun to align themselves along a similar path. This is a positive indicator that can support the synopsis that latter Balanced Scorecard designs are indeed more useful compared with the initial model proposed by Kaplan and Norton (1992) in that they are more likely to impact a NPO positively after the adoption of the model has been implemented. However, although modern Balanced Scorecard models have shown significant improvements and greater scope for utility, the evolution process is far from complete. The model can become far more attractive for adoption if financial values for pre and post case scenarios can be incorporated within the framework. Another key criterion for the adoption of the Balanced Scorecard within NPOs is the ability to demonstrate further added value through its adoption. When a NPO does adopt the Balanced Scorecard model, it can be implemented throughout each department and can be used as a successful strategic planning and performance management tool (Shulver et al, 2000).

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BOARD QUALITY AND THE PERFORMANCE OF INDONESIAN LISTED COMPANIES

Shamharir Abidin, Nurwati A. Ahmad-Zaluki*, Desi Ilona

Abstract

This paper provides an analysis on the effect of board quality on company performance. Using a sample of 133 companies listed on the Jakarta Stock Exchange in the year 2007, this study specifically examines whether *multiple directorships*, *director shareholding* and *board independence* (i.e. proxies for board quality) can be associated with company financial performance. This study also investigates the effect of audit committee characteristics (as proxied by *audit committee independence* and *financial expertise*) on company performance, while controlling for the effects of *leverage* and *size*.
With regard to board quality, the results indicate that only *board independence* is found to be associated with performance, though in the opposite direction. The direction of influence suggests that having too many independent directors (i.e. non-executive) might slow down the business as they might have a lack of detailed knowledge about the company's business, and are more concerned about their gatekeeper role. As expected, *leverage* and *size* are found to have a significant influence on company performance.

Keywords: Sarbanes-Oxley Act, Corporate Governance, Indonesia, Performance, Board Quality

**College of Business, Accounting Building, Universiti Utara Malaysia, 06010 UUM Sintok, Kedah Darul Aman, Malaysia*
Tel: +604-9283917
Fax: +604-9285762

Introduction

Since Berle and Means (1932), corporate governance has developed to be one of the most important aspects of today's corporations. In Asia, the issue of corporate governance has intensively been debated, especially after the late 1990's Asian Financial Crisis. The same has also been debated in Indonesia, where the financial crisis inevitable turned into a political crisis. More recently, the role and responsibilities of the board have been highlighted by regulators and academics around the world, in particular after the downfall of Enron, WorldCom and several other corporations in the US. In response to those high-profile collapses, the US government passed the Sarbanes-Oxley Act in 2002, which subsequently prompted many countries to promulgate a new corporate governance code. In Indonesia, the code was revised from the 2001 version and then re-issued in 2006.

Over time, the number of Indonesian's listed companies has been growing rapidly. For instance, in 2000, the number of listed companies in Indonesia was only 347 and in 2007, the number increased to 468. These changes account for 35% of growth since 2000 with a 4.3% growth rate per annum. In line with the increasing number of companies seeking capital from the public through the Jakarta Stock Exchange, the government has introduced several measures to ensure good practice of governance. Despite the steady growth in the numbers of listed companies, however, the performance of these companies has fluctuated over time. It is reported that in 2005, 17% of the listed companies experienced negative return on assets (ROA). Despite the percentage decreasing to 15% in 2006; the number was still considerably large (Ilona, 2008).

Poor company performance is believed to be caused by many factors. According to Porter (1991), the company's strategy and its implementation are the factors affecting company performance. It is also suggested that another factor that contributes to the companies' performance is corporate governance. The

response of corporate governance in Indonesia has been shown through the issuance of the Code of Corporate Governance. Indonesia's Corporate Governance Committee issued the Code in 2001 and in 2006, released a revised version. As mentioned by the Chairman of the National Committee on Governance, Mr. Achmad Nadiri, the code is expected to become '*a meaningful contribution*' for economic recovery in Indonesia. Amongst the objectives of the code are: (i) to achieve sustainable growth of a company through a management system, and (ii) to enhance the competitiveness of a company, both nationally and internationally.

Several studies have investigated the effect of corporate governance on company performance (e.g., Vafeas and Theodorou, 1998; Hossain et al., 2001; Callahan et al., 2002; Peng et al., 2003; Haniffa & Hudaib, 2006; Bennedsen et al., 2007). However, the findings of these studies, generally, are inconsistent. These include the studies that have been undertaken in Indonesia (e.g. Suaryana, 2005; Pudjiastuti & Mardiyah, 2007). However, it is important to note that, in general, Indonesian studies on the effects of corporate governance and company performance are still limited. In fact, since the revision of the Code of Corporate Governance has been released in 2006, to our knowledge, there are no Indonesian studies that have been undertaken to investigate the relationship between board structure and company performance. Hence, the present study aims to investigate the effect of the board quality on the company performance pos- 2006. This study is expected to contribute towards a better understanding of agency theory.

Using a sample of 133 companies listed on the Jakarta Stock Exchange in 2007, the results indicate that only *board independence* is associated with performance, though in the opposite direction. The direction of influence might suggest that having too many independent directors (i.e. non-executive) might slow down the business as they might have less detailed knowledge about the company's business, and are more concerned about their gatekeeping role. Consistent with prior studies, *leverage* and *size* are also found to be significant factors in determining company performance.

The remainder of this paper is organized as follows. The next section discusses related literature and outlines the research hypotheses. It is followed by a description of the data and methods. Then, the following section reports the results of the empirical analysis. The final section concludes the paper and offers some recommendations for future research.

Prior studies and hypotheses development

Agency theory assumes that there is a conflict of interest between principal and agent. It argues that the agent is motivated to pursue their own goals, rather than to increase the principal's wealth. According to the asymmetric information hypothesis, this conflict exists because the agent has access to more information than the principal. In order to reduce this agency conflict, the principal has to control the behavior of the agent through good corporate governance (Jensen & Meckling, 1976). This agency theory serves to underpin the relationship between corporate governance and company performance, including the role of the board of directors to improve a company's performance. The present study establishes the relationship between agency variables and performance by employing an agency theory perspective. Those agency variables include *multiple directorships*, *director shareholding*, *board independence*, *audit committee independence* and *audit committee financial expertise*.

Multiple Directorships

Fama (1980) and Fama & Jensen (1983) argue that *multiple directorships* may be valuable to companies. It has been argued that the directors who serve on multiple boards have broader experience, and network and commercial contacts (Mace, 1986). They are capable of providing profound advice and offer better monitoring. From a resource-based and resource-dependent perspective, directors with multiple directorships can be perceived as more intellectual, reputational and having better networking resources. These in turn will facilitate access to financial and human capital resources, provide timely advice and counsel when needed and make the decision process insightful (Van den Heuvel et al., 2006). Arguably, these directors will have more valuable director capabilities than directors with a single directorship. They have a higher potential for service effectiveness and thus can have positive effects on company performance. Therefore, the following hypothesis is proposed:

H_1: There is a significant relationship between multiple directorships and company performance.

Board of Commissioner Shareholding

Jensen & Meckling (1976) state that the extent of managers' shareholdings can reduce agency costs as it serves to align the interests of the management with those of other shareholders. To do so, it is suggested that management should be compensated with ownership (Jensen & Meckling 1976). With board ownership, it reduces the opportunistic behavior and therefore reduces the agency cost, and consequently will increase company performance. This argument is supported by several prior studies that report significant (albeit weak) relationships between directors' shareholdings and company performance (e.g., Craswell et al., 1997; Vafeas & Theodorou, 1998; Haniffa & Hudaib, 2006). Following that, the second hypothesis is proposed as follows:

H_2: There is a significant relationship between the directors' shareholding and company performance

Board Independence

Boards of commissioners are regarded as one of the most important control and monitoring mechanisms, especially in financial reporting. Members of the board can be categorized into two types, namely: executive and non-executive directors (Bennedsen et al., 2007). An executive director is generally a full-time employee, and a senior executive of the company who has responsibility in the day-to-day operations. They have direct responsibility for aspects of the business such as finance and marketing. They also help to formulate and implement corporate strategy. On the other hand, a non-executive director is appointed from outside. Non-executive directors are outside directors who monitor the decisions made by the executive directors. Non-executive directors are part-time and executive directors are full-time employees of the company. The empirical findings suggest that there is a relationship between the proportion of board membership (independent vs. non-independent) on the comprehensiveness of financial disclosure (Dehaene et al., 2001; Hossain et al., 2001; Haniffa & Hudaib, 2006; Bennedsen et al., 2007; Lefort & Urzua, 2008). Given the significant role of non-executive directors in monitoring the executive directors, the third hypothesis is proposed as follows:

H_3: There is a significant relationship between outside board independence and company performance

Audit Committee Independence

The role of audit committees is to ensure high quality financial reporting. Hence, an effective audit committee should have independent behavior. Spira (1999) argues that there are two aspects of independence. The first relates to a personal quality found in a particular individual (equivalent to independence in fact) and the second represents a notion of distance and detachment that is assumed to be essential to objective judgment (equivalent to independence in appearance).

Hsu (2007) found no association between audit committee independence and company value. Klein (2002) concluded that there is a negative relationship between independent audit committee and earnings management. Other scholars (e.g., Anderson et. al., 2004; Erickson et al., 2005; Chan & Li, 2008) find that there is a positive relationship between the audit committee independence and company performance. Thus, the fourth hypothesis is developed as follows:

H_4: There is a significant relationship between audit committee independence and company performance.

Audit Committee Financial Expertise

To effectively monitor and control managerial actions, especially the ones that relate to financial reporting, it is expected that the audit committee should posses some degree of financial expertise. Financial knowledge can help audit committees to perform their tasks, such as detecting material misstatements or assessing risky projects, more effectively. Financial expertise can be gained by audit committee members through employment or experience in either accounting or finance, or professional certification in accounting or finance.

Zhang et al. (2007) suggests that there is a relationship between audit committee quality (financial expertise) and internal control weaknesses. DeFond et al. (2005) found a significant relationship between audit committee accounting/financial expertise and the improvement of corporate governance. Other

researchers found a positive association between audit committee financial expertise and company performance (e.g., Al-Mudhaki & Joshi, 2004; Hsu, 2007; Chan & Li, 2008; Guner et al., 2008; Jiang, 2008). Based on prior findings, the following hypothesis is proposed:

H_5: There is a significant relationship between audit committee financial expertise and company performance.

Research methods

Sample Selection

The sample for the present study was selected from a list of companies listed on the Indonesian Stock Exchange (formerly known as the Jakarta Stock Exchange). As of 31 December, 2007, 468 companies were listed on the Exchange. However, of the 468 companies, forty-four were newly-listed companies and hence the first annual reports were not available for the financial year end for 2007 and were thus discarded. At the time of the data collection (i.e. August 2008), 291 companies had yet to submit their annual reports to the Exchange. This resulted in only 133 companies being included in the study.

Variables Measurement

The description of variables can be found in Table 1. The dependent variable, i.e. company performance, is measured using the ratio of return on assets (*roa*). In particular, it is measured as the earnings before tax divided by total assets of the companies.

There are eight independent variables. The board quality variables, which are governance-related variables, are proxied by multiple directorships (*multi_dir*), director's shareholding (*bod_own*), board independence (*bod_ind*), audit committee independence (*ac_ind*) and audit committee financial expertise (*ac_expert*).

Table 1. Variable Description

Variables	Code	Description
Company performance	*roa*	A proxy for company performance, as measured by return on assets (ROA)
Board quality	*multi_dir*	A proxy for board quality as measured by the percentage of commissioners who have multiple directorships
Board shareholding	*bod_own*	A proxy for board quality as measured by the amount of directors' shareholding to the total of shareholders
Board independence	*bod_ind*	A proxy for board quality (board independence) as measured by the percentage of outside commissioners relative to the total directors on the board
Audit committee independence	*ac_ind*	A proxy for board quality (audit committee independence) as measured by the proportion of the independent directors on the audit committee
Audit committee financial expertise	*ac_expert*	Audit committee financial expertise is measured by the proportion of the financial experts (experience in accounting) on the audit committee
Company size	*ln_size*	Natural log of company total assets
Company fixed assets to total assets	*fata*	Fixed assets to total assets
Leverage	*lev*	Total debt to total assets

Studies that utilize multiple directorships as a proxy for the quality of the board include Kiel & Nicloson, (2006) and Sarkar & Sarkar (2008). The variable is measured as the percentage of commissioners who have interlocked relationships (i.e. also director in other companies).

Meanwhile, Board of Commissioner shareholding is measured by the number of the directors' shareholding in the companies as suggested by Craswell, Taylor et al., 1997; Vafeas & Theodorou, 1998; and Haniffa & Hudaib, 2006. It is measured as the ratio of directors' shareholding to total shares outstanding.

Board independence is proxied by the ratio of outside commissioners to the total number of commissioners on the board. This measure has been employed by many researchers, such as Dehaene et al., (2001), Peng et al., (2003), Pudjiastuti & Mardiyah (2007), and Lefort & Urzua (2008).

To be consistent with Anderson, Manasi, & Reeb (2004), Erickson et al., (2005), Hsu (2007) and Chan and Li (2008), audit committee independence is measured as the proportion of the independent directors on the audit committee.

Audit committee financial expertise in this study is measured by using a measurement offered by many researchers (e.g. Al-Mudhaki & Joshi, 2004; Hsu, 2007; Chan & Li, 2008; Guner et al., 2008; Jiang, 2008). It is measured by seeing the proportion of the financial experts on the audit committee. Hence, the financial experts are categorized as personal work experience in accounting and finance.

To control for the effect of other variables on companies performance, three variables are also included in this study. The variables are: depreciable assets (*fata*), company size (*ln_size*) and leverage (*lev*). A depreciable asset is measured by the ratio of fixed assets to total asset (*fata*). Similar measure has been used by Hsu (2007). Meanwhile, the company size (*ln_size*) is measured by total assets (see for example: Hossain et al., 2001; Peng et al., 2003; Haniffa & Hudaib, 2006; Hsu, 2007; Pudjiastuti & Mardiyah, 2007). Finally, the leverage (*lev*) is measured by the ratio of total debts to total assets (see for example: Craswell et. al., 1997; Hossain et. al., 2001; Haniffa & Hudaib, 2006; Hsu, 2007).

Model

To estimate the effect of corporate governance variables on company performance, the present study utilized the Ordinary Least Square analysis. The following regression model was estimated:

$$roa = \beta_0 + \beta_1\, multi_dir + \beta_2\, bod_own + \beta_3\, ac_ind + \beta_4\, ac_ind + \beta_5\, ac_expert + \beta_6\, ln_size + \beta_7\, fata + \beta_8\, lev + \varepsilon$$

Results

Multivariate Analysis

To clean the data from classical assumption problems, several tests are used. Outliers are identified by using Grubb's extreme Studentised deviation test. It is based on the standard normal z-statistic:

$$Z = \frac{\text{mean - value}}{\text{SD}}$$

The mean and the standard deviation were calculated using all of the values. Therefore, the Z value is compared to a critical Z value. The null hypothesis was rejected if the computed Z value is greater than the critical Z value and that value is identified as an outlier (Barnett & Lewis, 1994). Once an outlier was identified, the value of that outlier is replaced to the next highest value. Grubb's test can only detect one outlier at a time; the procedure needs to be repeated until no further outliers are detected.

Multi-collinearity is used to check whether there is any relation among the independent variables. It uses two tests to ascertain whether there is any multi-collinearity problem, namely, the Pearson correlation and the Variance Inflation Factor (VIF). This can be seen in Table 2. If the result of the Pearson correlation is higher than 0.6, it means there is a relation among the independent variables (Anderson et al., 1996). However, the results indicate that the Pearson correlation is lower than 0.7. It can be concluded that there is no multi-collinearity problem.

Table 2. Result of Pearson correlation

	1	2	3	4	5	6	7	8	9
Roa	1.00								
multi_dir	0.07	1.00							
bod_own	-0.00	0.10	1.00						
bod_ind	-0.17	-0.21*	-0.01	1.00					
ac_ind	-0.11	-0.18*	-0.00	0.04	1.00				
ac_expert	-0.03	-0.05	-0.08	0.15	0.19*	1.00			
fata	0.00	0.12	0.16	-0.19*	0.03	-0.06	1.00		
lev	-0.40**	-0.10	-0.08	0.07	0.19*	0.05	-0.05	1.00	
ln_size	0.20*	-0.08	-0.12	0.13	0.27**	0.15	-0.09	0.08	1.00

Notes: Two-tailed, bold = significant at 5% level

The Pearson's result is also supported by the Variance Inflation Factor (VIF). VIF was used by many researchers to detect multi-collinearity problems (Gujarati, 1995). The border of tolerance value is 0.10, while the VIF border is 10 (Hair et. al., 1995). The result indicates that the VIF value for the two regression equations was below 10 and the tolerance value was 0.10. Thus, it can be concluded that there is no multi-collinearity. Furthermore, to test the autocorrelation, the Durbin-Watson method is used. The Durbin-Watson test (d) averaged 1.953, meaning that no serial correlations among the disturbance terms or the variables are independent.

The summary of the result of estimation on the influence of director quality on company performance can be seen in Table 3. F-statistic is 5.164 with a significance level of 0.000. This indicates that the model is far more fit due to the significance level being below 0.05. Therefore, this model can be interpreted with unbiased results (Gujarati, 1995). The second indicator of goodness of fit is based on adjusted R^2 due to it being more acceptable than R^2 (Gujarati, 1995). In addition, the adjusted R^2 indicates that 20% of the dependent variable (ROA) can be explained by the independent variables.

Table 3. Result of Regression of Board Quality and Company Performance

Variable	Coeff.	SE	t-value	p-value	VIF
Constant	0.01	0.04	0.29	0.77	
multi_dir	0.00	0.02	0.05	0.96	1.09
bod_own	0.03	1.35	0.02	0.98	1.05
bod_ind	-0.07	0.04	-2.13	***0.04***	1.11
ac_ind	-0.03	0.03	-1.06	0.29	1.18
ac_expert	-0.00	0.01	-0.16	0.87	1.07
Fata	-0.01	0.02	-0.27	0.79	1.08
Lev	-0.09	0.02	-4.91	***0.00***	1.05
ln_size	0.02	0.01	3.41	***0.01***	1.13
F stat = 5.164					
P value = 0.000					
R^2 = 0.250					
Adjusted R^2 = 0.202					

There are five hypotheses offered in this study. The statistical property used to see whether the hypotheses is accepted or rejected is for a P value ≤ 0.05. Of all five proxies of board quality, only board independence was found to be significantly related to company performance. However, the coefficient sign shows an adverse relationship. The results suggest that company performance will deteriorate when the board consists of a high number of non-executive directors. The results of a study by Agrawal & Knoeber (1996) might possibly offer some insight on why non-executive directors have a negative rather

than a positive impact on corporate financial performance. Among the explanations offered was that independent directors were added to boards in already poorly performing companies in order to improve the performance. Hermalin & Weisbach (1998) also presented the same results. However, upon further tests, Agrawal & Knoeber (1996) find that it is actually the board that caused the performance rather than otherwise. They contend that there are possibilities that the boards are expanded for political reasons, for instance, by including politicians, environmental activists or consumer representatives. The inclusion of this group of personalities has limited or reduced company performance. As put forward by Solomon and Solomon (2005) '…too great a proportion of independent or non-independents can swing the balance in the wrong direction'. In addition, the same authors also argue whether or not non-executive directors who are alleged to be independent are truly independent. Mace (1986) and Vancil (1987) for example, question the independence of non-executive directors when the appointment process itself is affected unduly by cronyism.

Of the three control variables used in this study; only leverage and size were found to be significantly associated with performance. The result shows that there is a negative significant relationship between leverage and company performance. This finding is consistent with the studies of Craswell et al. (1997), Hossain et al. (2001), Haniffa & Hudaib (2006) and Hsu (2007). As for the size variable, the result indicates that there is a positive significant relationship between size and company performance. This result is consistent with the studies of Hossain et al. (2001), Hsu (2007) and Pudjiastuti & Mardiyah (2007).

Conclusions

The objective of this study is to empirically investigate if a single aspect of corporate governance, namely board quality, affects company performance in Indonesia. Based on a sample of 133 companies listed on the Jakarta Stock Exchange in 2007, the present study examines if *multiple directorships*, *director shareholding* and *board independence* (i.e. proxies for board quality) can be associated with company financial performance. This study also investigates the effect of audit committee characteristics (as proxied by *audit committee independence* and *financial expertise*) on company performance, while controlling for the effects of *leverage* and *size.*

With regard to board quality, the results indicate that only *board independence* can be associated with performance, though in the opposite direction. The direction of influence might suggest that having too many independent directors (i.e. non-executive) might slow down the business as they might have lack of detailed knowledge about the company's business, and are more concerned about their gatekeeping role. Consistent with prior studies, *leverage* and *size* are also found to be significant determinants.

Of its importance, the results of this study help to establish a starting point for exploring empirically the importance of corporate governance structure after the publication of the revised Code of Corporate Governance for Indonesia in 2006. However, due to its limitations, the results of the study should be interpreted with caution. Firstly, this study only utilized the data from one fiscal year. Studies done with multiple periods of data might provide different findings, and be statistically more robust. Secondly, there is also the limitation that relates to model specifications. Due to sample size constraints, the study did not include all potential determinant variables. This inevitably might cause specification bias. As suggested by prior studies, company performance could also be explained by other corporate governance variables or other management related variables. The inclusion of these variables might improve the estimation power of the model. By considering those limitations, it is expected that future research should consider adding more data as well as including other aspects of corporate governance variables, such as characteristics of remuneration and nominating committees.

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DIRECTOR OWNERSHIP, OUTSIDE DIRECTORS AND COMMITMENT TO CORPORATE SOCIAL RESPONSIBILITY

Chen Ying*, Sidney Leung**

Abstract

This paper examines the effects of director ownership and the proportion of outside directors on firms' commitment to corporate social responsibility (CSR). Using a sample of 453 Hong Kong listed companies for 2005, we find that there is a non-linear relationship between the level of director ownership and firms' engagement in CSR behavior. Commitment to CSR first increases as the proportion of director ownership increases up to 50% and then decreases as that proportion of ownership grows higher. Further, the proportion of outside directors on the board exhibits a positive relationship with the level of CSR commitment. These results provide explanations for firms' commitment to CSR from the corporate governance perspective.

Keywords: Corporate Social Responsibility, Director Ownership, Board of Directors, Outside Directors

**Department of Accountancy, City University of Hong Kong*
Email: cying7@student.cityu.edu.hk
***Department of Accountancy, City University of Hong Kong, 83 Tat Chee Avenue, Kowloon, Hong Kong*
Tel: (852) 34437924
Fax: (852) 34420349
Email: acsleung@cityu.edu.hk

1. Introduction

During the past two decades, the idea of corporate social responsibility (CSR) has attracted a great deal of attention from management, investors, stakeholders, community activists and researchers. According to the European Commission (2002), in engaging in CSR, companies integrate social and environmental concerns in their daily business operations and in their interaction with their stakeholders on a voluntary basis. In today's globalized economy, social responsibility is an important aspect of corporate activities. In addition to performing well economically, companies need to undertake diverse socially responsible actions to ensure their survival and growth. Of the rich body of literature on CSR, most research has focused on the determinants of CSR (Roberts, 1992) and the association between CSR and corporate financial performance (Rowley and Shawn, 2000). As ownership structure can affect organizational objectives and management strategies in decision-making, some CSR studies have extended to the characteristics of corporate ownership (e.g., Zahra et al., 1993; Johnson and Greening, 1999) and corporate governance (e.g., Blair, 1995). According to stakeholder theory, companies should take the interests of their stakeholders into consideration when designing their business strategies (Freeman, 1984). Recently, corporate boards of directors have become increasingly involved in shaping company policies on a wide range of social and environmental issues (Ayuso, 2007). Thus, an investigation of how boards of directors affect CSR commitment is of great interest. In this study, we investigate the effects of director ownership and board independence on the commitment to CSR among Hong Kong firms.

Unlike the U.S. and many European countries, where firms are required to provide CSR reports on a largely mandatory basis, Hong Kong has a laissez-faire economy in which there is no requirement that companies either engage in or disclose CSR activities. In addition, corporate governance in Hong Kong differs substantially from that practiced in firms in Western countries. A central characteristic of Hong Kong companies is concentrated insider ownership and a majority of inside directors. Many listed firms in Hong Kong are subject to family control. On average, the executive directors of such companies hold around 38% of total shareholdings (Leung and Horwitz, 2004). Controlling families routinely appoint family members as key managers (chairmen or CEOs) or directors to represent family interests (Jaggi et

al., 2009; Leung and Horwitz, 2010). The traditional (Type I) agency problem between managers and shareholders in this type of firm is no longer important or severe because the concentrated shareholders have the incentive and ability to better monitor managers and reduce information asymmetry. However, when the ownership of insiders becomes concentrated, the insiders gain absolute control over the firm's operations and decision-making through voting rights. In this case, the agency problem shifts from the manager-shareholder to the conflict between the controlling and minority shareholders (Fan and Wong, 2002), a Type II agency problem. The controlling insiders have incentives and the ability to maximize private benefits by expropriating minority shareholders. Thus, Hong Kong firms provide a good setting in which to examine the association between CSR commitment and director ownership. Using a sample of 453 companies for 2005, we find a non-linear relationship between director ownership and corporate social behavior. CSR activities first increase as the proportion of director ownership increases up to 50% and then decrease as that proportion continues to climb. This finding is consistent with the prior literature examining the effects of director ownership and firm performance (Keasey et al., 1994), which suggests that increased director ownership helps to align the interests of the directors and the firm, thus improving firm performance. However, when the proportion of director ownership reaches a certain point, the entrenchment effect begins to dominate, as the directors are able to benefit themselves by expropriating minority shareholders, thereby reducing firm performance.

Outside directors are expected to be more responsive to balancing the objectives of various stakeholders and more aware of CSR (e.g., Webb, 2004). Our findings show that the proportion of outside directors on the board of a firm is positively associated with the extent of the firm's engagement in CSR activities. This result is consistent with Ibrahim and Angelidis (1995), who found that outside directors exhibit greater concern for CSR than inside directors.

This study contributes to the corporate board literature by extending CSR research from the corporate governance perspective by examining the relationships among director ownership, outside directors and CSR commitment. We provide evidence that the extent of firms' commitment to CSR is related to corporate board structure and ownership. In particular, the finding of a non-linear relationship between director ownership and CSR commitment provides insights into the impact of insider ownership and family control on firms' involvement in CSR.

2. Related Literature and Hypothesis Development

2.1. Background: CSR Commitment

The term CSR was first formalized by Bowen (1953) as a firm's obligation to follow lines of action that have socially desirable objectives and values. For many years, CSR has been largely discussed in terms of whether firms should act in socially responsible ways. Friedman (2007) suggests that firms are bonded only by legal guidelines and need not bear the costs of social conduct and responsibility. Therefore, maximizing shareholder value is the only objective of a firm and its managers. However, in recent years, the idea of CSR has become widely accepted and applied by firms. Increasing numbers of companies now publish CSR reports and discuss corporate social activities in their annual reports. Although the literature on the association between CSR and corporate financial performance is largely inconclusive, organizations are increasingly engaging in CSR strategies and activities to become more sustainable (Steurer et al., 2005). There is evidence that investors value CSR and that the firms that practice CSR are rewarded in the capital markets (Brammer et al., 2006).

Considering the potential benefits of CSR for the community and society, governments are generally in support of CSR engagement and disclosure. In the U.S., government agencies, such as the Federal Trade Commission and the Environmental Protection Agency, require firms to provide information on how they have fulfilled their social responsibilities. For example, listed companies in the U.S. are required to disclose environmental information in their annual reports, especially in the case of firms that can create potential environmental problems. In 2001, the French government issued "Nouvelles Regulations Economiques," the first formal regulation to require all listed companies in the Premier Marché to disclose information on their social and environmental impacts. This mandatory regulation also established an index for CSR disclosure, with listed companies required to disclose information related to employees, health and safety, human rights, community participation, and environmental and social concerns. Early in 1989, Australia initiated a National Strategy for Ecologically Sustainable Development to ensure economic, social and environmental sustainability (Petrovic-Lazarevic and Lazarevic, 2009).

Compared with Western countries, however, the Asian emerging markets lag behind in the concern and attention paid to CSR. Hong Kong, a laissez-faire economy that is largely free from government intervention, has no mandatory requirements for CSR reporting. Any commitment to CSR by Hong Kong firms is purely voluntary. Corporate governance in Hong Kong also differs substantially from that practiced in firms in Western countries. Hong Kong companies are mainly characterized by concentrated insider ownership and a majority of inside directors. Accordingly, in these firms, the agency problem between controlling and minority shareholders dominates the traditional agency problem between managers and shareholders.

2.2. CSR Commitment and Director Ownership

There are opposing views on the expected relationship between CSR and director ownership. On the one hand, increased director ownership is seen to facilitate greater involvement in CSR. The Type I principal-agent problem between managers and shareholders arises from the separation of ownership and control, which creates the potential for moral hazards and conflicts of interest between the two parties. Thus, managers have incentives to engage in non-maximizing firm value-added behavior (Jensen and Meckling, 1976). The prior literature has demonstrated that management ownership can reduce the Type I agency problem by bonding managerial actions to shareholders interests and enhancing managers' incentives for disclosure (Jensen and Murphy, 1990; Nagar et al., 2000; Leung and Horwitz, 2004). Because of the alignment effect, controlling insiders may be more diligent in managing the operations of their firms (Finkelstein, 1992) and work hard to satisfy the demands of stakeholders, as firms are typically dependent on stakeholders for the resources necessary to their survival and growth (Hillman and Keim, 2001). Furthermore, Anderson et al. (2003) suggest that dominant shareholders are more likely to be concerned with the long-term survival of firms and maintaining their own reputation. Thus, investing in socially responsible activities is a good way for controlling shareholders to signal to stakeholders that they are acting in the interests of the company. Such managers may have incentives to engage in corporate social activities, as commitment to CSR can serve to improve the firm's corporate reputation and image (Brammer and Pavelin, 2006).

There are various incentives for engaging in CSR (Baron, 2008). Consumers may appreciate a firm's engagement in CSR and be willing to pay more for the firm's products. Investors may also value this engagement in social responsibility by buying or holding the firm's equity shares. CSR can improve productivity, as a socially responsible approach to the rights and working environment of employees may induce employees to work harder or better for the firm. Because of the potential advantages associated with CSR, directors with substantial shareholdings and whose interests are thereby aligned with a firm's objectives will be more willing to invest in CSR activities. Prior studies (e.g., Zahra et al., 1993; Johnson and Greening, 1999) suggest that managers who have substantial ownership in a firm have more power to allocate resources among diverse stakeholders for performance enhancement activities. Based on this line of argument, voluntary CSR commitment is expected to be positively associated with director ownership.

On the other hand, when director ownership becomes highly concentrated, the Type II agency problem concerning the conflict between controlling and minority shareholders soon arises and may dominate the benefits of the reduction in the Type I agency problem. Directors with concentrated ownership have almost absolute control of the firm and have incentives to seek private benefits by expropriating minority shareholders (Fama and Jensen, 1983). Fan and Wong (2002) document a more serious conflict between controlling and minority shareholders in East Asian countries, where controlling family ownership is widespread and the legal protection of minority shareholders is relatively weak. Controlling directors have no fear of takeover because of their dominant voting rights, and they may care little about their firms' social reputation. Thus, investing less in CSR will increase a firm's cash flow and allow a director the discretion to use the cash to increase his or her own compensation and perquisites. Moreover, the cultural environment has been identified as a predictor of commitment to CSR in prior research (e.g., Waldman et al., 2006). Chinese society is characterized by high levels of power distance, which indicates that members of society accept that power is concentrated in the hands of few people and that they should obey their leaders without question. As Waldman et al. (2006) suggest, managers in cultures with high levels of power distance may be less concerned with the values of shareholders/owners than with their own and may feel less responsible for the welfare of the community or society. In short, in such a cultural environment, directors with concentrated ownership are likely to place personal gain above the interests of the firm and CSR. This line of argument suggests that voluntary CSR commitment will be reduced when director ownership is highly concentrated.

Given the foregoing views, we conjecture that the relationship between director ownership and CSR commitment may not be linear. That is, the extent of firms' commitment to CSR increases as the proportion of director ownership rises from a low to a moderate level. However, once director ownership becomes highly concentrated, the degree of commitment to CSR decreases. To test for the effects of low and high levels of director share ownership on firms' commitment to CSR, we establish the following related hypotheses.

H1a: When the level of director ownership is low, there is a positive association between director ownership and commitment to corporate social responsibility.

H1b: When the level of director ownership is high, there is a negative association between director ownership and commitment to corporate social responsibility.

2.3. CSR Commitment and Outside Directors

Outside directors are seen as crucial in limiting managerial discretionary behavior and protecting stakeholder interests because their roles and incentives are not compromised by the executive directors or top managers (Fama and Jensen, 1983). Wang and Dewhirst (1992) report that outside directors are strongly oriented toward stakeholders. Outside directors may care more about community, employment and environmental issues than insider directors, who focus primarily on financial performance. Therefore, a greater representation of outside directors is more likely to promote corporate social commitment. In addition, an increase in the number of outside directors is likely to increase the diversity of the board in terms of race, ethnicity and gender. A company with a diversity of board members will be more knowledgeable about the changing demands of various stakeholders and be more sensitive to social commitments (Zahra et al., 1993).

Johnson and Greening (1999) examine the effects of outside director representation on two dimensions of CSR: people and product quality. They find a significant positive relationship between outside director representation and both of the CSR dimensions, which suggests that outside directors may have profit and non-profit goals. Ibrahim and Angelidis (1995) and Ibrahim et al. (2003) find that outside directors exhibit greater concern about the philanthropic components of corporate responsibility than inside directors. Webb (2004) shows that socially responsible firms tend to have a higher percentage of outside directors. Furthermore, Zahra and Stanton (1988) argue that outside directors are especially interested in demonstrating compliance with regulations and socially responsible behavior out of concern for building a good image and reputation. Therefore, we expect that the representation of outside directors will be positively associated with voluntary CSR commitment. Hence, our second hypothesis is stated as follows.

H2: There is a positive association between the proportion of outside directors and commitment to corporate social responsibility.

3. Research Design

3.1. Sample

The sample used in this study to examine the relationships among director ownership, outside directors and CSR commitment covers 453 companies listed in Hong Kong in 2005. Following the Asian Financial Crisis in 1997, many changes have been made to the corporate governance requirements and accounting standards in Hong Kong, including a new Code on Corporate Governance Practices, which became effective on 1 January, 2005. Accordingly, the selection of 2005 as the sample year allows us to evaluate the research questions under the latest corporate governance regime.

Our sample selection procedure started with searching the *Global Vantage* database for the set of Hong Kong firms with financial data available for 2005. Data on CSR commitment, director ownership and the proportion of outside directors were manually collected from annual reports. The financial data that needed to be controlled in our analysis were obtained directly from the *Global Vantage* database. After deleting any missing or extreme values in the control variables, the final sample for the regression analysis consisted of 453 observations.

3.2. Measurement of Variables

Dependent variable – CSR Commitment

The definition of what constitutes CSR commitment varies in prior studies. The concept is multi-dimensional in nature, covering issues related to the environment, community, employment, and the treatment of customers and suppliers. Regulatory authorities and professional bodies in Hong Kong have no guidelines for CSR. To avoid making subjective judgments on the list of possible CSR activities employed in this study, we have borrowed the CSR section of the checklist used by the Singapore Panel of Best Annual Report Award for Singaporean listed companies. This checklist includes six dimensions of CSR activities: *environmental, energy, product, fair business, community* and *other information*. We use this checklist because Singapore has a similar economic background to Hong Kong. Both economies are emerging markets with internationally renowned capital markets. Listed companies in Hong Kong and Singapore are characterized by concentrated insider ownership. They also face similar cultural environments, as both societies are predominantly Chinese.

To construct an index to measure the extent of commitment to CSR, we assign a score of "1" to firms that disclose information, and "0" otherwise, for each of the six categories of CSR activities contained in the checklist. We then combine the scores of all six categories to generate a single aggregate measure, with an overall score ranging from 0 to 6. Table 1 provides information on the frequency of the reported CSR activities for each item. The common CSR item is "community involvement," which comprises community, education, arts and health-related activities. Corporate engagement in other CSR items is uncommon. As the number of firms disclosing three or more CSR dimensions is very low (only 2.2%), we combine them, with a CSR score of 2 indicating the highest level of CSR commitment. As a result, the dependent variable, CSR commitment (CSRC), is defined as an ordinal variable with three outcomes: 0, 1 and 2.

Table 1. Dimensions of Corporate Social Commitment

Six Dimensions	1	0
Environmental activities and disclosures	31(5.74%)	509(94.26%)
Energy conservation and products' energy efficiency	7(1.3%)	533(98.7%)
Fair business practices	3(0.56%)	537(99.44%)
Community involvement	185(34.26%)	355(65.74%)
Product safety	6(1.11%)	534(98.89%)
Other social responsibility disclosures	23(4.26%)	517(95.74%)

Environmental activities includes pollution control, prevention or repair of damage to the environment and, other environment disclosures.
Energy: includes conservation of energy activities and, energy efficiency of products.
Fair business practices: includes policies and activities with respect to women in employment, the disabled, responsibility to suppliers and customers.
Community involvement: includes community activities, health-related activities, education and the arts, and other community involvement such as participation in the productivities movement.
Products: includes product safety, pollution controls and other product-related social information.
Others: includes general social policy statements and the availability of additional information.

Experimental variables

The main independent variables are director ownership and board independence. Director ownership (DO) is defined as the fraction of issued shares held by all directors divided by the total number of issued shares. Our conjecture is that there is a non-linear relationship between director ownership and commitment to CSR. That is, the level of CSR commitment differs between high and low levels of director ownership. We use two methods to test this expectation. First, we include director ownership (DO) and the square of director ownership (SQDO) in the regression model to examine the non-linear

relationship between director ownership and CSR commitment. Second, we use a piecewise linear model that allows the effect of ownership on the commitment to CSR to differ on different ownership levels.[37]

Hong Kong firms classify directors as executive directors and non-executive directors, including independent non-executive directors. A number of Hong Kong firms do not designate which non-executive directors are independent such directors. Non-executive directors are expected to play similar roles in advising and monitoring managers and to have incentives to build a good reputation, regardless of whether they are formally classified as independent non-executive directors. Thus, we measure the representation of outside directors by the proportion of non-executive directors on corporate boards.[38]

Control Variables

In our analysis of the effects of director ownership and outside directors on CSR commitment, we control for the following factors that may affect the level of that commitment: firm size (*lnsale*), performance (*roa*), leverage (*Leverage*), auditor status (*big5)*, growth (market to book ratio, *pbratio*), information asymmetry (correlation between earnings and market return, *infoas*), issue of new equity capital (*neec*) and age of public listing (*age_public*). Larger firms are more likely to commit themselves to corporate social activities, because they are easy "targets" of social concern and may feel it is necessary to make efforts to establish their social reputation. Further, as political costs are highly dependent on firm size (Watts and Zimmerman, 1978), firms may attempt to reduce these costs by engaging in CSR. Many prior studies (e.g., Trotman and Bradley, 1981; Belkaoui and Karpik, 1989; Hackston and Milne, 1996) show a positive relationship between CSR commitment and firm size. In line with the extant CSR literature, we also control for financial performance, which is measured as return on total assets. Leverage and whether a firm issues new equity capital are used to capture creditors' control. Roberts (1992) argues that the greater the degree to which a corporation relies on debt financing to fund capital projects, the greater the degree to which the firm will be committed to social responsibility. Growth, firm age and industry classification (Roberts, 1992; Amir et al., 2006) are also common controls in the analysis of corporate social performance. Our model also controls for auditor type and information asymmetry, which are usually used as control variables in disclosure studies.

3.3. The Regression Model

The following ordered regression model is used in our main analyses.

$$\mathrm{CSRC} = \beta_0 + \beta_1 DO + \beta_2 SQDO + \beta_3 \mathrm{pned} + \beta_4 big5 + \beta_5 roa + \beta_6 leverage + \beta_7 size + \beta_8 pbratio + \beta_9 infoas + \beta_{10} neec + \beta_{11} age_public + \beta_i industry_i + \varepsilon$$

Where:

CSRC = an ordinal variable coded "0" for firms that report none of the six CSR activities in their annual reports; "1" for firms that report only one CSR activity, and "2" for firms that report at least two CSR activities in their annual reports;
DO = the fraction of shares owned by directors on the board;
SQDO = the square of DO;
pned = the proportion of non-executive directors on the board;
big5 = dummy variable coded as "1" if the firm is audited by a big-5 auditor, and "0" otherwise;
roa = return on total asset to measure firm performance, defined as the ratio of net income after tax over total assets;
leverage = firm leverage, defined as the ratio of total debt over total assets;
size = natural log of a firm's net sales (lnsale) to measure firm size;

[37] We first calculate the turning point of director ownership based on the following model: $\mathrm{CSRC} = \beta_0 + \beta_1 DO + \beta_2 SQDO + \beta_i control\ variables_i + \varepsilon$. Using the estimated β_1 and β_2, the calculated turning point in director ownership is 50%. We then adopt 50% of director ownership as the cutoff to identify high and low levels of DO in the piecewise regression model.

[38] We also employ the proportion of independent non-executive directors as an additional test. The results are qualitatively similar to those reported in the tables.

pbratio = market-to-book equity value ratio;
infoas = correlation between earnings and market returns;
neec = dummy variable coded "1" if a firm issued new share capital in the current year in excess of five percent of the last-year ordinary share capital, and "0" otherwise;
age_public = number of years a firm has been publicly listed; and
Industry = dummy variables. We control for industry effects based on the two-digit SIC codes.

4. Empirical Results

4.1. Descriptive Statistics

Descriptive statistics for all of the variables are shown in Table 2. With regard to disclosure of their commitment to CSR, 58.06% of the sample firms provided no information on any social commitments, 35.54% engaged in only one type of social activity, and 6.4% committed to two or more dimensions of CSR.

The mean proportion of non-executive directors is 50%, which represents an increase of around 10% over the past ten years, as the average representation of non-executive directors on corporate boards in Hong Kong firms was 40% in 1996 (Leung and Horwitz, 2004). The implication is that the board independence of Hong Kong companies has improved and, in the majority of firms, executive directors cannot dominate the boards of directors. The mean proportion of shares held by directors to total shares issued is 37%, and the maximum proportion of director ownership is as high as 94%. This suggests that directors in these firms have significant control over decision-making and voting power.

Table 2. Descriptive Statistics for the Main Variables

Panel A					
Continuous variables	N	Mean	Min	Max	Std. Dev.
pned	453	0.50	0.21	0.95	0.14
DO	453	0.37	0.00	0.91	0.26
SQDO	453	0.20	0.00	0.83	0.19
roa	453	0.00	-2.64	0.57	0.25
leverage	453	0.99	-56.56	86.35	5.30
pbratio	453	1.23	0.03	18.70	2.09
infoas	453	0.20	-1.00	1.00	0.57
lnsale	453	6.33	-0.43	10.93	1.77

Panel B				
OrdinalVariable	0	1	2	Total
CSRC	263(58.06%)	161(35.54%)	29(6.4%)	453(100%)

Panel C			
Dummy variables	0	1	Total
big5	121(26.71%)	332(73.29%)	453(100%)
neec	367(81.02%)	86(19.98%)	453(100%)

CSRC: an ordinal variable, which equals 0 if a firm does not disclose CSR in year t; 1 if a firm only discloses one type of socially responsible activity; and 2 if a firm discloses at least two types of CSR activity.
pned: the proportion of non-executive directors on the board in year t.
DO: the measurement of the proportion of director ownership, it equals the sum of shares owned by executive directors, non-executive directors and independent non-executive directors divided by the total common shares issued in year t.
SQDO: the square of director ownership
big5: Equals 1 if the auditor of a firm is a Big 5, and 0 otherwise
roa: return on total assets. It equals net income in year t divided by total assets at the end of year.
leverage: Debt/ equity ratio
lnsale: natural log of the firm's net sales in year t.
pbratio: market to book value
infoas: correlation between earnings and market return
neec: if a firm issued new external equity capital in year t, it is calculated as 1 if there is a 5% increase in 2005 in the common shares issued in t-1, ,and 0 otherwise

Table 3 describes the statistical correlations between all of the variables. The correlation analysis suggests that large companies are associated with good performance and a higher proportion of non-executive directors. Those with a higher level of debt and a longer listing history are more likely to commit to CSR . Auditor type (big5) is also positively correlated with CSR activities. Overall, the correlation coefficients between the independent variables are not high and do not suggest a serious multi-collinearity problem in the regression analysis.

Table 3. Pearson Correlation Coefficients between the Variables

	CSRC	pned	DO	SQDO	big5	roa	leverage	pbratio	infoas	lnsale	neec
pned	0.122**										
DO	0.048	-0.096*									
SQDO	0.039	-0.075	0.956**								
big5	0.244**	0.011	-0.018	0.026							
roa	0.220**	-0.034	0.0899*	0.086*	0.245**						
leverage	0.090*	0.041	-0.029	-0.030	-0.007	0.010					
pbratio	0.049	0.034	-0.088*	-0.080	-0.128**	-0.177**	-0.015				
infoas	-0.014	-0.072	0.056	0.025	0.067	0.051	-0.089	-0.030			
lnsale	0.439**	-0.029	-0.012	-0.002	0.447**	0.400**	0.094*	-0.207**	0.043		
neec	-0.038	0.000	-0.062	-0.085	-0.122**	-0.045	0.060	0.144**	-0.090	-0.066	
age_public	0.164	-0.002	-0.044	-0.054	0.102	0.101	0.038	-0.012	-0.015	0.205**	0.080

**Correlation is significant at the 0.01 level (two-tailed);
*Correlation is significant at the 0.05 level (two-tailed).

4.2. Regression Results

Table 4 reports the results of the ordered logistic regression model, with three outcomes (0, 1 and 2) for the dependent variable (CSRC). The results show that CSR commitment is not only significantly and *positively* associated with director ownership but also significantly and *negatively* associated with the square of director ownership. The positive coefficient of *DO* suggests that increased director ownership above a low level helps to increase CSR commitment. An increase in director ownership from a low level may reduce the Type I agency problem and align the interests of the directors and the firm, leading to greater investment in socially responsible activities to benefit the corporate image, improve productivity, and reward customers and investors. The estimated coefficient of *SQDO* is negative (-3.605) and significant at the 0.10 level for the two-tailed test, which suggests that when director ownership becomes highly concentrated, commitment to CSR is reduced. These findings are consistent with the alignment effect at moderate levels of director ownership and the entrenchment effect once director ownership becomes highly concentrated. More specifically, the results suggest that once the proportion of director ownership exceeds a certain degree of concentration, e.g., the cutoff point of 50% of *DO* in our sample, the Type II agency problem becomes severe, as the insiders gain absolute power over the firms and are able to pursue private benefits by expropriating the interests of minority shareholders. After this point, controlling directors are no longer interested in CSR because they have no fear of takeover and care less about the social reputation of their firms. Overall, the results from the ordered logistic regressions support hypotheses 1a and 1b.

Table 4 also provides support for the notion that a higher proportion of non-executive directors increases commitment to CSR. The estimated coefficient on *pned* is, as expected, positive (2.092) and significant at the 0.05 level, for the two-tailed test. This result suggests that non-executive directors promote engagement in, and commitment to, CSR.

The results also show that control variables such as firm size, performance and leverage are, as expected, all significantly and positively associated with CSR commitment, which is consistent with the prior literature.

Table 4. Main Regression Results

	Predicted Sign	Coefficients	t-statistics
pned	+	2.092**	2.55
DO	+	3.604**	2.30
SQDO	-	-3.605*	-1.75
big5	+	0.314	0.99
roa	+	2.047**	2.49
leverage	+	0.0301**	2.02
pbratio	+	0.122**	2.52
infoas	+	-0.0618	-0.32
lnsale	+	0.586***	5.88
neec	+	-0.127	-0.43
age_public	+	0.0116	1.00
Industry	--	control	control
N	--	453	
adj. R^2		0.1913	

t statistics in parentheses
* $p< 0.1$, ** $p< 0.05$, *** $p< 0.01$
Industry: industry dummy variables. We use the two_digit SIC code to identify industry. The industry dummy is coded as '1' if a firm is classified as a certain type of industry, and '0' otherwise. The whole sample covers 48 industries, of which 31 industries have less than 10 firms that disclose CSR activities. Thus, these industries are merged into one dummy variable SIC_10.
See the definitions of other variables in the notes to Table 2.

4.3. Additional Tests

4.3.1. Piecewise regression

To further test the non-linear relationship between director ownership and commitment to CSR, we adopt a piecewise regression method. First, we calculate the turning point in the proportion of director ownership based on the estimated coefficients of DO (3.3031) and SQDO (-3.3025), as shown in Column 1 of Table 5. The turning point is equal to 50%. Based on this turning point, we create two new variables as follows.

DO_low = the actual fraction of director ownership if DO is no larger than 50% of total outstanding shares (i.e., DO ≤ 50%); or equals 50% if DO is larger than 50% of total outstanding shares (i.e., DO > 50%).

DO_high = the actual fraction of director ownership minus 50% if DO is larger than 50% of total outstanding shares (i.e., DO > 50%); or equals 0 if DO is no larger than 50% of total outstanding shares (i.e., DO ≤ 50%).

Then, we run the following piecewise model.

$$\text{CSRC} = \beta_0 + \beta_1 DO_low + \beta_2 DO_high + \beta_3 \text{pned} + \beta_4 big5 + \beta_5 roa + \beta_6 leverage + \beta_7 size + \beta_8 pbratio + \beta_9 infoas + \beta_{10} neec + \beta_{11}\, age_public + \beta_i industry_i + \varepsilon$$

The results are reported in Column 2 of Table 5. The estimated coefficient of *DO_low* is significantly positive (2.059), whereas that of *DO_high* is significantly negative (-3.978). These results further confirm our finding that high and low levels of director ownership have different impacts on CSR commitment. When the proportion of director ownership is low, increasing that ownership helps to increase the alignment of interests, as directors may be encouraged to invest in socially responsible activities for the benefit of the firm. However, when director ownership becomes concentrated, controlling directors are less inclined to engage in CSR.

Table 5. Piecewise Regression

	Column 1:The turning point		Column 2: Piecewise regression	
	Coefficient	t-statistics	Coefficient	t-statistics
DO	3.303**	2.14	--	--
SQDO	-3.303*	-1.65	--	--
DO_low			2.059***	2.85
DO_high			-3.978*	-1.93
pned			2.059***	2.55
big5	0.327	1.06	0.316	0.99
roa	2.201***	2.60	2.030**	2.45
leverage	0.0273*	1.90	0.0315**	2.11
pbratio	0.121**	2.42	0.122**	2.49
infoas	-0.120	-0.63	-0.0512	-0.26
lnsale	0.575***	5.71	0.585***	5.86
neec	-0.118	-0.40	-0.0996	-0.33
age_public	0.0122	1.03	0.0128	1.10
Industry	control		control	
N	453		453	
adj. R^2	**0.1821**		**0.1924**	

t statistics in parentheses
* $p< 0.1$, ** $p< 0.05$, *** $p< 0.01$
DO_low=percentage of director ownership if DO<=50%; 50% if DO>50%
DO_high=percentage of director ownership-50% if DO>50%; 0 if DO<=50%
See the definitions of other variables in the notes to Table 2.

4.3.2. The impact of director ownership on the association between outside directors and CSR commitment

The prior literature suggests that inside directors with high levels of ownership can influence the appointment of non-executive directors (Johnson et al., 1996; Anderson and Reeb, 2004). Studies have also shown that non-executive directors may not be sufficiently independent and able to perform their monitoring roles effectively in firms with a high degree of insider ownership (Jaggi et al., 2009). In this additional analysis, we further examine the association between the proportion of non-executive directors and commitment to CSR in relation to different levels of director ownership. Based on the previously identified turning point, we divide the full sample into two groups, "high-level director ownership" (DO_high >= 50%) and "low-level director ownership" (DO_low < 50%), and then rerun the model without the ownership variable for each group. The results, presented in Table 6, show that the estimated coefficient on *pned* is positive (3.385) and strongly significant at p-value < 0.003 for the low-level director ownership group, whereas *pned* is negative (-0.0525) but statistically insignificant for the high-level group. These results suggest that independent non-executive directors are less effective in firms with concentrated director ownership and, therefore, weaken the firms' commitment to CSR. They also suggest that effective monitoring by outside directors is conditional on the extent of director ownership.

Table 6. Regressions of CSR Commitment for High and Low Director Ownership Sub-samples

	High director ownership		Low director ownership	
	Coefficient	t-statistics	Coefficient	t-statistics
pned	-0.0525	-0.04	3.385***	2.98
big5	0.609	1.28	0.0683	0.14
roa	1.133	1.53	2.614**	2.14
leverage	0.0389	1.19	0.0338**	1.98
pbratio	0.354***	2.63	0.106*	1.69
infoas	0.0562	0.18	-0.0532	-0.20
lnsale	0.523***	3.36	0.637***	4.37
neec	0.387	0.79	-0.529	-1.21
age_public	-0.0205	-0.78	0.0310**	2.11
Industry	control		control	
N	176		277	
adj. R^2	0.1453		0.2631	

t statistics in parentheses
* $p< 0.1$, ** $p< 0.05$, *** $p< 0.01$
See the definitions of variables in the notes to Table 2.

4.3.3. The use of alternative CSRC measures

We also consider an alternative test using logistic regression. We define CSRCC as a dummy variable that equals "1" if a firm discloses at least one dimension of CSR activities, and "0" if it reports no CSR activities. The unreported results show that the coefficient of DO is significantly positive (4.461) at the 0.01 level, and that of SQDO is significantly negative (-4.585) at the 0.05 level. The coefficient of *pned* remains positive (1.685) and is statistically significant, with a p-value < 0.031. The results of the robustness checks further support the main results.

5. Conclusion

In this paper, we examine the effects of director ownership and the representation of non-executive directors on firms' commitment to CSR. Unlike the U.S. and most European countries, where firms are required to provide CSR reports on a mandatory basis, Hong Kong has a laissez-faire economy in which there are no requirements for CSR activities or disclosures. Furthermore, in most East Asian countries, including Hong Kong, concentrated director ownership is a prevalent phenomenon. Many listed companies in Hong Kong are subject to family control. These firms are able to overcome the traditional agency problem between managers and shareholders because the substantial shareholders are able to conduct effective monitoring by appointing family members as directors on the board, thereby reducing managerial incentives to engage in short-term behavior. However, when insider ownership becomes highly concentrated, insiders gain absolute control over the operations, decision-making and voting power of firms. In this case, the agency problem shifts from the manager-shareholder to the conflict between the controlling and minority shareholders (Fan and Wong, 2002). The controlling insiders have the incentive and ability to maximize private benefits. Thus, Hong Kong provides a good setting in which to examine the research questions presented in this paper.

The results of this study provide evidence of a non-linear association between commitment to CSR and director ownership. In line with our hypothesis, when the level of director ownership is low, increased ownership helps to increase the alignment of interest, and directors are encouraged to invest in CSR activities that benefit the corporate reputation and contribute to building stable relationships with customers, suppliers and investors (Ibrahim and Angelidis, 1995; Ibrahim et al., 2003). However, when director ownership becomes highly concentrated, the entrenchment/expropriation effect becomes severe and can dominate. The controlling directors have the incentive and ability to divert firms' resources to gain personal private benefits. CSR may thus become a low priority because they have no fear of takeover or stakeholder challenge.

Our results also show that firms with a higher proportion of non-executive directors are more likely to commit themselves to CSR activities. This finding is consistent with the notion that independent non-executive directors have a strong stakeholder orientation and are more concerned about CSR than insiders. However, after controlling for director ownership, we find that a higher proportion of non-executive directors is not associated with greater commitment to CSR in firms with a high level of director ownership. This suggests that independent non-executive directors are more effective in firms with low levels of director ownership than in firms with concentrated director ownership.

This study links the literature on CSR and corporate governance by showing that the effects of director ownership on the commitment to CSR are non-linear. Firms with moderate levels of director ownership are more likely to engage in socially responsible activities. However, firms with highly concentrated director ownership are less likely to regard social commitment as a top priority. The lack of association between independent boards and CSR commitment in firms with concentrated director ownership suggests that regulators and policy makers should closely monitor the effectiveness of outside directors appointed to firms with high levels of director ownership.

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