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The Impact of Corporate Governance Regulations on Board Independence and Quality of Financial Information Reporting: A Proposed Study

Mohd. Yussoff Ibrahim^a, Ayoib Che Ahmad^b, Satirenjit Kaur Johl^a, Haseeb Ur Rahman^{a*}

* Corresponding author: Haseeb Ur Rahman, haseebbaboo@yahoo.com

^aDepartment of Management & Humanities, Universiti Teknologi PETRONAS, Bandar Seri Iskandar, Tronoh, 31750, Perak, Malaysia

^bSchool of Accountancy, Universiti Utara Malaysia, Sintok, Kedah, Malaysia

Abstract

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The recent corporate scandals revealed misreporting and poor quality of financial information reporting. The misreporting evidenced that board of directors couldn't ensure its role of effective monitoring to minimize management's conflicts, frauds and misrepresentations of information. These in turn, diverted the attention of regulators and policy makers towards independence of the board among others. Malaysia, like other countries, also advised independence of the board in its third code of corporate governance (MCCG 2012) introduced in March, 2012. The code recommended independence of the board to ensure effective monitoring of management. Agency theory and many CG regulations around the world posit that strengthening independence of the board improves firms' reporting quality of financial information. Therefore, this paper proposes to investigate how some specific attributes of the new regulation regarding independence of the board impacted quality of financial information reporting in Malaysian listed companies. The paper proposes a pre and post analysis of the code by comparing 2 years pre (2010-11) and 2 years post (2013-14) context of the code. The proposed study will contribute to the limited literature with inconclusive results. Moreover, it will also provide insights for shareholders, banks, financial institution, security commission and Bursa Malaysia.

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Keywords: Corporate Governance; Separate Leadership; Independent chair; Proportion of independent directors; Reporting Quality of financial information.



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1. Introduction

Financial reporting is a medium of communication between corporation and its stakeholders about different financial activities of the firm. The reporting aims to inform and updates public, government, shareholders, employees, bankers, suppliers, creditors and other stakeholders about financial health of the firm (Bello, 2009; Johnson, Khurana, & Reynolds, 2002; Kantudu & Samaila, 2015). Signaling theory also posits the decisions of outside stakeholders are highly depend upon the information public by corporations. The theory assumes that financial reporting is a sole source of information for outsiders which signals firms' current as well as expected financial health in future (Akerlof, 1970). Good quality of reported financial information facilitates investors and other stakeholders in their decisions (Kamaruzaman, Mazlifa, & Maisarah, 2009).

Keeping in view of the importance of financial reporting, it should be reliable, relevant, meaningful and disseminated in time to assist its users (Hassan & Bello, 2013). Reported financial information reporting should be reliable, comparable and understandable in order to better serve all the stakeholders in their decision making (Kamaruzaman et al., 2009). The reporting is reliable if it carries what it aims to carry by following the norms and principles of international reporting standards. The financial information reporting should observe compliance to accounting standards as well as regulatory authorities in preparation of financial statements. Moreover, the reporting is reliable if it depicts true picture by reporting correct values free from errors and biasness (Bello, 2009; International Accounting Standard Board, 2008).

Financial reporting is reliable if representative, neutral and verifiable. It should be clear enough to be easily understood by its users without undue struggle (International Accounting Standard Board, 2008). It should also possess the qualities of relevancy and verifiability (Bello, 2009; Bushman, Chen, Engel, & Smith, 2004). Verifiability of reporting means the presentation and acquisition of financial information in a fair manner. Moreover, financial reporting is reliable if it passes any direct or indirect verification and cross validation of information the way these computed (Johnson, 2005).

However, it is very difficult to achieve the quality of reporting fully free from bias and errors. Financial statements are prepared on the basis of some projections and assumptions regarding future. The quality of financial reporting is affected when these assumptions deviate or turned otherwise (Johnson, 2005). International Accounting Standard Board also admit this fact by requiring a certain level of accuracy of the financial information (International Accounting Standard Board, 2008).

Financial reporting quality evolved as a topic of great interest for legislators, regulators, policy makers, shareholders, practitioners, academicians and researchers around the world since Cadbury report 1992. The topic got further popularity due to high public demand for transparency, integrity, reliability and disclosure of financial information after the accounting frauds of Enron, WorldCom, Marconi, and Parmalat, etc. (Hashim & Devi, 2007). Subsequently, the regulators and practitioners stressed upon strengthening corporate governance structure for ensuring good quality of financial reporting (Cohen, Krishnamoorthy, & Wright, 2004).

Malaysia, like other countries, also faced a number of accounting scandals like Perwaja Steel, Technology Resources Industries (TRI), Transmile, Megan Media, Malaysian Airlines System (MAS) and Port Klang Free Zone (PKFZ), Linear Corporation, Kenmark Industrial Co. Berhad and Sime

Darby. These scandals revealed the fraudulent reporting of financial information which disclosed inefficiency of board structure and composition in Malaysian firms (Angabini & Wasiuzzaman, 2011; Norwani, Mohamad, & Chek, 2011). International and domestic forums like OECD (2011), UNCTAD, (2010) and CG blue print document also stressed upon structure, independence and nomination of the board (OECD, 2011; UNCTAD, 2010). Subsequently, Malaysia revised corporate governance regulations (MCCG 2007) by introducing new CG code - MCCG 2012 in March, 2012 (PwC, 2012). The code addressed independence of the board among others. Therefore, this paper proposes to investigate how some specific attributes of the code like separate leadership, independent chair and proportion of independent directors affected reporting quality of financial information of the Malaysian non-financial listed companies. The proposed two year pre and two year post analysis from 2010 to 2013 will highlight the impact of the code, if any.

2. Literature Review

Investors always have serious concerns and doubts about the quality of financial reporting. Board has a crucial role to ensure this quality especially in developing countries (AL-Dhamari & Ismail, 2014). Thus, this study focuses some existing and some of the newly recommended attributes of MCCG 2012 in relation to reporting quality of financial information.

2.1. Separate Leadership and Financial Reporting Quality

Separating the two roles enhances independence of the board. The separation of the two roles of chairman and CEO share substantial powers between the two individuals (Cadbury Committee, 1992) which enhances independence of the board. Agency theory posits that independence of the board strengthens its monitoring role which improves the quality of information reporting by ensuring transparency. Therefore, the theory supports the separation of two strong roles (Hamid, 2008; Jensen, 1993). The separation of chairman from CEO strengthens internal control system of the firm which improves the quality of financial reporting (Beekes, Pope, & Young, 2004; Hamid, 2008). Therefore, separate leadership has positive impact on the quality of financial reporting (Kantudu & Samaila, 2015). Firms practicing separate leadership have good quality of financial reporting than those practice duality (Beekes et al., 2004).

The duality impairs quality of financial information and its reporting (Byard, Li, & Weintrop, 2006). Firms practice CEO duality are more inclined towards earning management than the firms with separate leadership in Malaysian context (Rahman & Haniffa, 2005). Therefore, CEO duality or combined leadership has negative impact on the quality of financial reporting (Hamid, 2008; Jensen, 1993).

The CEO becomes more powerful when acts as chairman of the board (Beasley, 1996). The extra power weakens monitoring role of the board (Cadbury Committee, 1992) which result in poor internal control system (Abbott, Park, & Parker, 2000). Subsequently, the firms practice dual leadership inclined to fraudulent transactions and irregularities in financial statements (Beasley, 1996). The duality of CEO increases violations of accounting principles. These in turn, affect the quality of financial reporting which endangers solvency of the firm (Dechow, Sloan, & Sweeney, 1996).

Therefore, the principles and regulations of good corporate governance discourage and oppose dual leadership. Accordingly, MCCG 2012 also recommended to separate leadership structure of the board in listed companies of the country.

However, in contrast there are many studies reported no significant relation between leadership structure and financial reporting quality in different contexts (Ahmed, Hossain, & Adams, 2006; Bradbury, Mak, & Tan, 2006; Petra, 2007). It is argued that CEO duality has no negative impact on credibility of financial statements in a study of 20 banks in Nigeria (Dabor & Adeyemi, 2009).

To sum up, previous literature regarding the relationship between separate leadership and financial reporting quality produced mixed results. The mixed results and introduction of new code (MCCG 2012) which advised separating the two roles necessitate further investigation of the relationship in Malaysian context. Therefore, on the basis of agency theory, this paper proposes to investigate the relationship between separate leadership and financial reporting quality of the Malaysian listed companies from 2010 to 2013 in pre and post context of the code. Following are the hypotheses for proposed further investigation.

H1 (a): Separate leadership has positive association with firms' financial reporting quality before MCGG 2012.

H1 (b): Separate leadership has positive association with firms' financial reporting quality after MCGG 2012.

2.2. Independent chair and financial reporting quality

Chair of the board is independent if held by non-executive or independent director of the board. Independent and experienced director is a suitable choice for the chair of board (Coombes & Wong, 2004). Independent director having knowledge and experience of the industry better leads the board (Carrott, 2008). Independent chair of the board strengthens independence of the board which ensures monitoring role of the board (Hashim & Devi, 2010; Petra, 2007, 2005). Therefore, ideal board has independent or non-executive chair (Felton & Wong, 2004).

Independent chair of the board is effective as independent directors have comparatively more time to look into the matters of board (Condit & Hess, 2003). Moreover, the chair has an edge to acquire private information from external market (Haniffa & Cooke, 2002). These in turn, strengthens monitoring role of the board which controls the practices of earning management that improves the quality of firms' financial reporting. However, it is advised that independent or non-executive chairman shouldn't be an ex-CEO of the firm in order to avoid any conflict of interests or roles (Carrott, 2008; Conger & Riggio, 2007). If independent chairman has no previous link or relation to the firm, he has no or less bias which improves firms' financial integrity and reporting quality (Al-Zyoud, 2012).

The non-executive or independent chair of the board also found in positive association with reporting quality of financial information in Malaysian firms (Hashim & Devi, 2010). The quality of financial information reporting is better in the firms with independent chair of the board than the firms without in Malaysian context (AL-Dhamari & Ismail, 2014). Accordingly, the MCGG 2012

recommended independent chair of the board in Malaysian listed companies. However, in contrast, it is argued that the relationship between non-executive chair of the board and financial reporting quality is complex and unknown in Malaysian context (Haniffa & Cooke, 2002).

To sum up, previous literature regarding the relationship between independent chair of the board and financial reporting quality is limited and mixed. Moreover, the introduction of MCCG 2012 also highlighted the need for further investigation of the relationship in Malaysia. Therefore, this paper proposes further investigation of the relationship on the basis of agency theory in pre and post context of the code. Following are the hypotheses for proposed further investigation in pre and post context of the code.

H2 (a): Independent chair of the board has positive association with firms' financial reporting quality before MCCG 2012.

H2 (b): Independent chair of the board has positive association with firms' financial reporting quality after MCCG 2012.

2.3. Proportion of Independent Directors and Financial Reporting Quality

The quality of financial information reporting greatly depends upon monitoring role of the board. If the board ensures effective monitoring of CEO, executives and management, it improves the quality of financial information reporting (Hamid, 2008; Jensen, 1993). However, only an independent board can better ensure effective monitoring role of the board. Agency theory posits that proportion of independent directors on the board means its independence (Fama & Jensen, 1983; Jensen & Meckling, 1976; Jensen, 1986). Independent directors are considered to be free from the influence of management which strengthens independence of the board (Beasley, 1996; Dechow et al., 1996). Independent board improves the quality of financial information disseminated to public (Beekes et al., 2004).

Independent directors ensure that the system, methods and principles of accounting being employed are valid, acceptable and better serve the desired objectives with transparency (Kent & Stewart, 2008). They enhance efficiency of the board by ensuring the quality, quantity and timing of the dissemination for financial information (Kantudu & Samaila, 2015). Many empirical studies endorse that proportion of independent directors on the board improves quality of information reporting (Firth, Fung, & Rui, 2007; Vafeas, 2005). The boards with majority of independent directors are good in detecting frauds and irregularities of financial statements (Beasley, 1996). The higher representation of non-executive directors on the board has no or less violations of Generally Accepted Accounting Principles (GAAP) (Dechow et al., 1996). Hence, they have positive association with the credibility of financial statements (Dabor & Adeyemi, 2009).

In contrast, it is also argued that independent directors lack competency to ensure effective monitoring of managers. Therefore, their presence on the board has no association with the quality of firms' financial reporting (Ahmed et al., 2006; Bradbury et al., 2006; Petra, 2007). There is no significant relation between the proportion of non-executive directors on the board and information disclosure (Ho & Wong, 2001).

To sum up, the relationship between proportion of independent directors on the board and financial reporting quality is inconclusive (AL-Dhamari & Ismail, 2014) which necessitates further investigation (Ho & Wong, 2001; Klein, 2002; Petra, 2007; Xie, Davidson, & DaDalt, 2003). Moreover, the introduction of new code (MCCG 2012) in Malaysia which recommended majority of independent directors on the board also necessitates further investigation of the relationship in Malaysian context. Therefore, this paper by following agency theory, proposes further investigation of the relationship between proportion of independent directors on the board and financial reporting quality of the Malaysian listed companies from 2010 to 2013 in pre and post context of the code. Following are the hypotheses for the proposed further investigation.

H3 (a): The proportion of independent directors on the board has positive association with firms' financial reporting quality before MCCG 2012.

H3 (b): The proportion of independent directors on the board has positive association with firms' financial reporting quality after MCCG 2012.

3. Scope and Methodology

The proposed sample of the study is 300 listed companies selected through stratified random sampling from all sectors of Malaysian economy except banks, insurance and financial companies from a total of 960 companies listed on Bursa Malaysia at the end of financial year 2009 (www.bursamalaysia.com). Random sampling reduces the systematic bias by giving equal chance of selection to every unit of population. The proposed data for separate leadership structure, independent chair and proportion of independent directors will be collected through content analysis of the annual reports of the sample firms while the data for financial reporting quality will be extracted from DATASTREAM. Separate leadership and independent chair of the board will be measured by dummy variables coded as 1 for yes and 0 otherwise. Proportion of independent directors will be measured by proportion of independent director to total number of directors on the board. The reporting quality of financial information will be measured by Modified Jones Model of earning management (Beest, Braam, & Boelens, 2009). The paper proposes descriptive statistics, Pearson's and Spearman's correlation matrixes and multiple regressions through STATA package 13 for analyzing data of both sub periods (pre 2010-11 and post 2013-14) separately. The results of both periods are also proposed to be compared by conducting paired T test and Welch ANNOVA so that find the distinct impact of the code, if any.

4. Significance and Contribution of the Proposed Study

The MCCG 2012 recommended independence of the board for Malaysian listed companies. However, no empirical study has yet investigated the impact of MCCG 2012 on financial reporting quality after enactment of the code. Moreover, previous limited literature regarding the relationship between independence of the board and reporting quality is inconclusive and mostly based in developed countries (Klai & Omri, 2011). Therefore, the proposed study will not only contribute to the

literature but will also provide policy insights for regulators, policy makers and authorities of developing countries.

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