

BOARD COMPOSITION, MIMETIC BEHAVIOUR AND CORPORATE VOLUNTARY DISCLOSURES

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Abstract

This study examines the effects of board composition and mimetic behaviour on the extent and credibility of corporate voluntary disclosure. The investigation is based on the annual reports of 155 Malaysian listed companies during the period when these companies faced new corporate governance regulation. This study provides evidence that under the influence of dominant owners on board, management voluntary disclosure decisions are driven by incentives to conform when their company is structured to meet expectations of good corporate governance. Such incentive seems to override incentives to disclose credible information to outside investors.

Keywords: Voluntary disclosure, board composition, mimetic behaviour, legitimacy

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1. Introduction

Calls for corporate transparency as a matter of good corporate governance practice create uncertainty regarding appropriate extent of management voluntary disclosures. Managers are subjected to substantial pressure to voluntarily disclose as a matter of good corporate governance practice or otherwise risk potential loss of legitimacy regarding their activities. However, managers' disclosure incentives for legitimization purposes may outweigh their incentive to communicate credible information as monitoring mechanism to investors. Alignment of managers and investors interests can be achieved through monitoring of managers' activities by the board of directors (Fama & Jensen, 1983; Healy & Palepu, 2001). However, prior empirical evidence on the relationship between voluntary disclosure and board composition provides mixed results. In particular, the evidence provided in relation to East Asian countries focused on independent non-executive directors' reputation incentives as an explanation for these directors to perform their monitoring role. However, these studies lack satisfactory explanation with regard to the potential influence of dominant owners on these directors monitoring role. Where independent non-executive directors are appointed by these owners, being the same individual they are supposed to monitor, there is a potential risk of collusion between these two parties (Patelli & Prencipe, 2007). Hence, omitting the potential influence of dominant owners will not provide satisfactory conclusion to the hypothesized relationship.

The aim of this study is to examine the effects of board composition and mimetic behaviour for conformity on corporate voluntary disclosure. In particular, it is contended in this study that such disclosure decisions, in terms of both the extent and credibility of the information disclosed, is a complex balance between management incentives to promote efficient governance of their companies or to conform for legitimization purposes.

2. Literature review and generation of hypotheses

2.1 Board Composition and Corporate Voluntary Disclosure

The influence of board composition on managers' voluntary disclosure decisions in this study is examined by independent variables related to family members on the board and the monitoring role of independent non-executive directors.

2.2 Family Members on Board

Prior studies suggest that family owned companies gained control of the company by nominating family members on the board of directors (e.g. Chen & Jaggi, 2000 and Ho & Wong, 2001). Further, this can also suggest the existence of dominant group of shareholders or a substantial shareholder with strong influence on the board's decision. Such influence could impair the directors' independence and could lead to higher risk of

collusion between independent non-executive directors and family owners (Patelli & Prencipe, 2007). Prior empirical evidence suggests that these directors support major decisions in favour of family owners rather than outside investors (C. J. P. Chen & Jaggi, 2000; Leung & Horwitz, 2004).

The potential entrenchment effect of family owners on voluntary disclosure can be mitigated by greater demand for detailed disclosure of voluntary information by outside investors (Wang, 2006). However, outside investors' role in Malaysia may be an ineffective control mechanism as outside investors' activism is still developing. Hence, this study formulates the following hypothesis:

H1: The percentage of family members on the board is significantly negatively related to the extent of voluntary disclosure.

2.3 Independent Non-Executive Directors

Fama & Jensen (1983) suggest that board composed of higher percentage of independent non-executive directors strengthened board's independence of management and thus is more effective monitors. With regard to the association between the independent non – executive directors and managers' disclosure tendencies, the evidence is limited and mixed. For example, several studies show that these directors are associated with more comprehensive mandatory financial disclosures (Chen & Jaggi, 2000), several others show that these directors are negatively associated with the extent of management voluntary disclosures (Gul & Leung, 2004; Eng & Mak, 2003) while some other studies find no significant associations (e.g. Haniffa & Cooke, 2002 and Ho & Wong, 2002). Prior studies suggest that independent non-executive directors potentially protect the interests of outside investors even in companies characterized by concentrated ownership (Shleifer & Vishny, 1997). However, when these directors are appointed by the dominant owners, there is a possible collusion between these two parties. Nevertheless, this study expects that the potential effect of this risk will be constrained by regulatory efforts in strengthening corporate governance and transparency in Malaysia (Cheng & Courtenay, 2006). Hence, this study formulates the following hypothesis:

H2: The percentage of independent non-executive directors on the board is significantly positively related to the extent of voluntary disclosure.

2.4 Mimetic Behaviour for Conformity in Corporate Voluntary Disclosure

Under uncertain conditions, institutional theory suggests that social influence lead an organization to imitate the practices of those companies that are viewed to be more legitimate and successful than others (Aerts, Cormier, & Magnan, 2006; DiMaggio & Powell, 1983). This study focuses on board interlock and industry concentration as mechanisms that can facilitate managers' mimetic behavior in relation to their voluntary disclosure practices.

2.5 Board Interlock

Board interlock refers to appointment of director, either executive or independent non-executive director, on multiple boards. Prior studies provide evidence that board interlocks allow focal company to imitate specific and multiple policies of other companies (Brandes et al., 2006; Westphal et al., 2001). Imitation is possible since the directors can learn decision-making processes through monitoring management decisions and also from direct participation in decision making of other boards (Westphal et al., 2001). In addition, board interlock also has the prospects of facilitating managers to imitate the decision process of other companies. This imitation strategy is known as second-order imitation (Westphal et al., 2001).

Management disclosure practices that conform to other companies practicing more transparent disclosure will be perceived as legitimate by regulators and investors (e.g. Aerts et al., 2006 and Brandes et al., 2005). Further, managers can communicate impressions of good corporate governance practices to these social actors. Hence, this study formulates the following hypothesis:

H3: The percentage of board interlocks is significantly positively related to the extent of voluntary disclosure.

2.6 Industry Concentration

The second mechanism that can facilitate managers' incentives to imitate voluntary disclosure practices of other companies is through network of companies within the same industry. In choosing a model to imitate, companies perceived as a leader or model practicing the legitimate activities will provide a strong model for other companies to assimilate (Aerts et al., 2006; Touron, 2005).

In this study, managers' desire to portray positive interpretations of their company's corporate governance practices is expected to influence them to assimilate other companies practicing more transparent

voluntary disclosure practices. This will allow them to justify their actions and deflect criticisms regarding their voluntary disclosure and corporate governance practices (Aerts et al., 2006; Brandes et al., 2006). This leads to the following hypothesis:

H4: The percentage of industry concentration is significantly positively related to the extent of voluntary disclosure.

2.7 Extent of Voluntary Disclosure and Return-Earning Relation

This study also investigates the credibility of the voluntary information disclosed by the managers. Even though managers have incentives to make credible voluntary disclosures to communicate that they are acting in the interests of outside owners and that good corporate governance structures are in place, agency conflicts potentially affect the credibility of management voluntary disclosures (Healy & Palepu, 2001).

As inferred by findings in Lundholm & Myers (2002), only credible management voluntary disclosures provide useful information to investors. They demonstrate that voluntary disclosure activity provides useful information to investors by changing their expectation about the company's future performance as reflected in the stock price. This implies that credible corporate voluntary disclosure activity reflects management's tendency to publicly reveal value relevant information about current and future earnings that are impounded in the stock price. It is contended in this study that enhanced voluntary disclosure viewed as credible by outside investors will be positively related to return-earnings relation. This leads to the following hypothesis:

H5: The extent of voluntary disclosure is significantly positively related to the current stock return and earnings relation.

3. Methodology

All the hypotheses will be tested using a sample of 155 companies listed on the main board of Bursa Malaysia at the end of the year 2002. The definition and measurement of variables is listed in Table 1.

Table 1. Definition and Measurement of Variables

Variable Acronym	Definition	Measurement
VDISC	The extent of five categories of voluntary disclosure	Number of points awarded to each company across all the categories (score of "1" if item is disclosed and "0" if not)
FAM	Family members as defined by S122A of the Malaysian Companies Act, 1965	Percentage of family members on board to total number of directors on the board
INED	Independent non-executive directors as defined by MCCG	Percentage of the independent non – executive directors to the total number of board members
INTER	Board interlocks	Percentage of total number of independent non – executive directors with appointments on other boards divided by the number of total board members
INDC	Industry concentration	Percentage of the total sales made by the largest two companies in the industry to the total sales of that industry
CRET	Current annual stock returns	Buy-and-hold returns for the 12-month period starting six months after the company's prior financial year end
CEARN	Annual reported earnings in year t	Income before extraordinary items as reported in companies' income statements
FEARN	Change in annual earnings in year t	Annual earnings for year t less prior year (t-1) annual reported earnings
FRET	Expected realized future earnings	Sum of income before extraordinary items reported in the income statements for the three years following year t (years t + 1, t + 2 and t + 3)

4. Analysis and results

4.1 Descriptive Statistics

Descriptive statistics for independent variables used in this study are given in Table 2. Percentage of FAM ranges from 0% to 100%, while the average value for INED is 37.98%. On average, 42.39% of these directors are also board members of other public listed companies (INTER). The average value for INDC is 25.11%.

The mean CRET are negative 0.20% and the mean CEARN are negative 1.27%. These values suggest declining performance among some of the companies in the sample during the current period of study. In contrast, the mean FEARN and FRET are 8.58% and 1.17% respectively, indicating improve performance over the future years.

Table 2. Descriptive Statistics of Independent Variables

Independent Variables	Minimum	Maximum	Mean	Std. Deviation
FAM (%)	0.00	100.00	20.31	22.04
INED (%)	25.00	57.14	37.98	6.27
INTER (%)	0.00	100.00	42.39	25.55
INDC (%)	12.47	68.30	25.11	9.95
SIZE (RM MIL)	15	16,204	1,326	2,300
PROF (%)	-102.23	145.54	7.18	23.97
GEAR (%)	0.00	559.40	25.60	49.20
CRET (%)	-11.49	9.65	-0.20	2.93
CEARN (%)	-107.58	35.45	-1.27	23.04
CHEARN (%)	-108.22	590.44	4.33	56.08
FEARN (%)	-372.40	158.71	8.58	63.21
FRET (%)	-12.07	50.63	1.17	6.54

4.2 Multivariate Analysis

Hypotheses H1, H2, H3 and H4 are examined based on model 1, while hypothesis H5 is examined based on model 2. The regression models are as follows.

$$\text{Model 1: VDISC} = \beta_0 + \beta_2 \text{FAM} + \beta_3 \text{INED} + \beta_4 \text{INTER} + \beta_5 \text{INDC} + \beta_7 \text{SIZE} + \beta_8 \text{GEAR} + \beta_9 \text{PROF} + \varepsilon_t$$

$$\text{Model 2: CRET}_t = \beta_0 + \beta_1 \text{CEARN}_t + \beta_2 \text{CHEARN}_t + \beta_3 \text{FEARN}_t + \beta_4 \text{FRET}_t + \varepsilon_t$$

where variable definitions are given in Table 1.

Examination of H5 requires VDISC to be included as independent variable and interaction terms with the independent variables in model 2. The extended regression model 2 is stated as follows.

$$\text{Model 2a: CRET}_t = \beta_0 + \beta_1 \text{CEARN}_t + \beta_2 \text{CHEARN}_t + \beta_3 \text{FEARN}_t + \beta_4 \text{FRET}_t + \beta_5 \text{VDISC}_t + \beta_6 \text{VDISCCEARN}_t + \beta_7 \text{VDISCHEARN}_t + \beta_8 \text{VDISCFEARN}_t + \beta_9 \text{VDISCFRET}_t + \varepsilon_t$$

The results based on model 1 are presented in Table 3 while the results based on model 2 are shown in Table 4.

Table 3. Multiple Regression Results for Factors Affecting the Extent of Voluntary Disclosure

Dependent Variable: VDISC (Extent of voluntary disclosure) R Square = 44.5%, Adjusted R Square = 41.9%, F = 16.485, Sig. = 0.000			
Variables	Beta	t	Sig.
(Constant)			0.849
FAM	-0.185	-2.885	0.005* * *
INED	-0.030	-0.476	0.635
INTER	0.116	1.756	0.081*
INDC	0.004	0.057	0.954
SIZE	0.493	7.681	0.000* * *
GEAR	-0.046	-0.736	0.463
PROF	0.270	4.097	0.000* * *

Coefficient for each variable is shown with *t* – statistics in parentheses

* Significant at 10% level (1-tailed test); * * Significant at 5% level (1-tailed test);

* * * Significant at 1% level (1-tailed test)

Table 4. Comparison of the return-earnings regression results (model 2) and the return-earnings–disclosure results (model 2a)

Dependent Variable: CRET (Current annual stock returns)		
	Model 2	Model 2a
Adjusted R ²	0.188	0.189
F-value	9.936	4.976
Significance	0.000	0.000
(Constant)	1.000 (0.000)	0.775 (0.287)
CEARN	0.938 (-0.078)	0.608 (-0.515)
CHEARN	0.135 (1.505)	0.041* * (2.062)
FEARN	0.000* * * (4.562)	0.000* * * (4.645)
FRET	0.882 (0.334)	0.129 (-1.528)
VDISC	-	0.862 (0.174)
VDISC*CEARN	-	0.672 (-0.424)
VDISC*CHEARN	-	0.074* (1.801)
VDISC*FEARN	-	0.883 (-0.147)
VDISC*FRET	-	0.194 (-1.304)

Coefficient for each variable is shown with *t* – statistics in parentheses

* Significant at 10% level (1-tailed test); * * Significant at 5% level (1-tailed test);

* * * Significant at 1% level (1-tailed test)

First, the results in Table 3 reveal that FAM is significantly negatively related to the extent of VDISC (at sig. < 0.01%). Therefore, H1 is accepted. This is consistent with the argument that higher percentage of FAM indicates the existence of a dominant group of shareholders or a substantial shareholder that could influence the board's decision to nominate family members to the board. Accordingly, these companies are likely to be closely held or owner managed with greater access to internal information. As such, family owners do not have to rely extensively on public disclosure to monitor their investments (e.g. Chau & Gray, 2002; Haniffa &

Cooke, 2002). The opportunities to expropriate outside investors wealth by family owners due to lesser public disclosure will further reduce managers/owners incentives to disclose detailed voluntary information.

Second, the results in Table 3 reveal a non significant relationship between INED and VDISC. As such, H2 is not accepted. This indicates that the presence of regulatory authorities' emphasis on board independence has not increased the independent non-executive directors concern for their reputation. Accordingly, they have lesser incentives to perform their monitoring activities by exerting pressure on managers to disclose voluntary information to outside investors (Haniffa & Cooke, 2002; Nazli & Weetman, 2006).

Third, H3 predicts that INTER will be positively related to the extent of VDISC and the result in Table 3 supports this hypothesis. Therefore, H3 is accepted. This confirms the argument that board interlocks allow the independent non-executive directors at focal companies to learn specific or multiple policy decisions in relation to voluntary disclosure strategy. Consequently, this accelerates the awareness to disclose higher voluntary information among them and to influence managers' voluntary disclosure decisions at the focal companies.

Managers' imitation strategy facilitated by board interlocks and the strong influence of family owners infer a possible collusion between independent non-executive directors and family owners. In such situation, the independent non-executive directors are more likely to support the controlling owners in major decisions (Leung & Horwitz, 2004). Hence, this study infers that these directors support family owners by influencing managers to increase voluntary information for legitimacy purposes. Further, it also offers a possible explanation to the insignificant relationship of INED and VDISC (test of H2).

Fourth, H4 predicts that companies operating in highly concentrated industries are associated with higher level of VDISC. However, the result in Table 3 indicates no significant relationship between these two variables. Hence, H4 is rejected.

Finally, H5 predicts that the greater the extent of VDISC, the more positive is the relationship between current annual stock returns and future earnings. Table 4 presents the results for model 2 when VDISC is not included while results for model 2a include the effects of VDISC. The results in model 2 reveal that the future earnings variable is significant at 1% level (t value = 4.562). This finding indicates the importance of future earnings in explaining the variation in the current stock returns (Lundholm & Myers, 2002; Luo et al., 2006). However, the results in model 2a show no significant effect of VDISC on current annual stock returns, but future earnings continue to show positive significant relations. These suggest that voluntary disclosure is not viewed as credible to investors in Malaysia. The insignificant change in the adjusted R^2 in both models further supports this suggestion. As such, H5 is not accepted.

5. Conclusion and limitations

This study provides evidence that under the influence of dominant owners on board, management voluntary disclosure decisions are driven by incentives to conform when their company is structured to meet expectations of good corporate governance. Instead of exerting pressure on management to increase voluntary disclosure to outside investors, the results infer that independent non-executive directors support management increase in voluntary disclosure of their activities for legitimacy purposes. Such disclosure practice seems to override management incentives to disclose credible information to outside investors. These findings provide some evidence to corporate governance regulators in improving corporate governance, other policy makers in strengthening capital market environment and to investment community who rely on corporate disclosures in making their decisions.

There are some limitations in this study. In particular, theoretical and empirical research suggests that returns and future earnings are affected by various corporate governance mechanisms (Bushman et al., 2004). Future research can be extended to integrate other corporate governance mechanisms as well as other categories of corporate disclosures.

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