LEADERSHIP STRUCTURE AND FIRM PERFORMANCE BY USING CORRECT PROXIES AND ORGANIZATIONAL THEORIES

Kashif Rashid*, Sardar M.N. Islam**

Abstract

Leadership structure is an important determinant in affecting the value of a firm in developing and developed markets. There is a lack of consensus among the researchers on the leadership structure and the value of a firm (LSVF) relationship. Furthermore, the correct proxy to value a firm has not been used to test its relationship with the mode of leadership in these financial markets. The current study contributes to the literature related to the LSVF by using a correct proxy to value a firm and interpreting the results of the model in the light of important management theories. The tests for incremental regression and correlation are also performed. By using the data for 120 listed companies, the result for the study suggests that dual leadership structure improves the value of a firm supporting the stewardship theory in the selected markets. Finally, results related to the role of control variables suggest that lower debt, efficient regulatory authority, optimal utilization of assets and informational efficiency have a value adding impact on the value for shareholders in these markets. The results for the study provide new insights into the LSVF relationship and are of value to academics and policy makers in the selected markets.

Keywords: Corporate Governance, Board Size, Shareholders' Value, Regulatory Authority and CEO Duality

**Centre for Strategic Economic Studies and Financial Modeling Program*
Victoria University
PO Box 14428, Melbourne, Victoria 3001, Australia
***Centre for Strategic Economic Studies and Financial Modeling Program*
Victoria University
PO Box 14428, Melbourne, Victoria 3001, AustraliaEmail: sardar.islam@vu.edu.au

Introduction

The literature related to the role of CEO duality in affecting the value of a firm in developed and developing markets is inconclusive. Stoeberl and Sherony (1985), Donaldson (1990), Alexander et al. (1993), Donaldson and Davis (1991, 1994), Coles et al. (2001) and Haniffa and Cooke (2002) find a positive relationship between dual leadership structure and the value of a firm. Similarly, Brickley et al. (1997) by using an accounting measure for the firms' performance find a positive relationship between dual leadership structure and shareholders' value. Furthermore, Tian and Lau (2001) and Peng et al. (2007) perform their research on the role of leadership structure and the value of a firm on Chinese companies and find a positive relationship between dual leadership structure and the value of a firm. Finally, Cornett et al. (2008) in their study conducted on the LSVF relationship in the developed market find a positive relationship between dual leadership structure and the value of a firm.

On the contrary, Fama and Jensen (1983), Rechner and Dalton (1991), White and lngrassia (1992), Pi and Timme (1993), Jensen (1993: 36), Boyd (1994) and Chen et al. (2005) find a negative relationship between dual leadership structure and the value of a firm. Baliga et al. (1996), Daily and Dalton (1997), Dalton et al. (1998), Rhoades et al. (2001), Dulewicz and Herbert (2004), Kang and Zardkoohi (2005) and Schmid and Zimmermann (2008) (in their study on Swiss firms) do not find any significant role of the leadership structure in affecting the value of a firm.

In addition to the diverging views, the critical analysis of the existing literature is as follows. Fosberg and Nelson (1999) in their study on the role of CEO duality in affecting a firm performance use market based measure of firms' performance (market to book value ratio). Their finding suggests that dual leadership structure does not bring any significant change in the value of a firm. Similarly, Al Farooque et al. (2007) use similar measures (e.g. market to book value ratio) to perform their study on the LSVF relationship in the developing (Bangladeshi) market, and Elsayed (2007) uses return on total assets in his study on the LSVF relationship of firms listed in the Egyptian Stock market. Both find an insignificant role of dual leadership structure in affecting the value of a firm in these markets.

Bliss et al. (2007) conduct their study on the relationship between the CEO duality and the audit fees in Malaysian firms. Similarly, Kakabadse et al. (2006) perform the study on the chairman-CEO relationship and its impact on the effectiveness of the board. These researchers have not performed their studies on the role

of leadership structure in affecting the value of a firm in combined markets.

Palmon and Wald (2002) undertake their study on the role of leadership structure in affecting the value of a firm, but have used accounting measures of firms' profitability. Finally, Lam and Lee (2008) perform their study on the LSVF relationship on companies listed at Hong Kong Securities Exchange. They have used return on assets (ROA) and return on equity (ROE) as dependent variables to test their relationship with the type of leadership structure in this market.

The abovementioned discussion suggests inconclusive results on the LSVF relationship in affecting the value of a firm. Furthermore, the correct proxy for firms' performance (Tobin's Q) has not been used in the previous studies.

This paper bridges the gap in the literature by using the correct proxy to value a firm for the firms of developing and developed markets. The result shows that the CEO duality improves shareholders' value in these markets supporting stewardship theory. The results related to the role of control variables suggest that an efficient regulatory authority, lower debt, informational efficiency and efficient utilization of assets improve the value of a firm in these markets.

Following the introduction, the rest of the paper is structured as follows. Section 2 presents the literature review. Section 3 discusses the hypothesis development. Similarly, Section 4 presents the methodology of the study. Section 5 explains the results for the model and finally, conclusion is presented in Section 6.

Literature Review

This section comprises of the discussion on the characteristics of the selected markets and explanation about the role of external and internal corporate governance instruments. The details related to the characteristics of developed and developing financial markets are as follows. The pillars of developed markets are efficient stock market, powerful regulatory framework, diversified portfolios, prudent board, lower debt and liquid financial market (Wei, 2003). These characteristics further suggest that managers are an important corporate governance instrument in the developed market. Finally, there is a better governance of agency conflicts between shareholders and managers in this market (Heinrich, 2002).

On the contrary, the important components for foundation of a developing market are as follows. Powerful blockholders, higher debt, undiversified portfolios, infant regulatory authority, inefficient market, pyramidal and cross shareholding and better governance of agency cost between the creditors and managers in this market (Rashid and Islam, 2008).

The two main types of markets include developing and developed financial markets. These markets are categorized on the basis of the development of the financial sectors and sophistication of financial instruments used in these economies to handle risk and provide returns to shareholders. The developed financial market uses better instruments to hedge the portfolios and protect the rights of shareholders compared to the developing financial market (Hunt and Terry, 2005). Australia is considered to be the developed market as strong regulatory law holds, protecting the interests of shareholders in this market. On the contrary, the Malaysian market uses less sophisticated instruments and has higher level of imperfections, which makes it qualify as a developing market.

The two main types of corporate governance instruments include external and internal governance mechanisms. The external regulatory mechanisms are majority shareholders and regulatory authority in the market (Rashid and Islam, 2009). The majority shareholders perform a constructive role in affecting the value of a firm in the developing country as they reduce the free riding from the market (Grossman and Hart, 1982). Free riding problem occurs when some of the shareholders avoid paying any cost in monitoring the management of a firm. The literature also suggests that the majority shareholders have played a vital role in removing the poor performing board of directors. This led to the improved value of a firm as the board started doing its fiduciary duties in a proper manner (Yafeh and Yosha, 2003).

Regulatory authorities in the developed financial market are efficient and powerful. Black (2001) suggests that the regulatory authority in the developed market reduces tunneling (over and under investment of the free cash flow). The judiciary in the developed market is also well-educated and is aware about the corporate crimes. The effective regulatory regime reduces the imperfect contracting in the market (Nenova, 2003). The firm also incorporates democratic provisions (investors friendly) in the presence of an efficient regulatory regime in a financial system (Gompers et al. 2003).

Similar to the role of external corporate governance instruments, the internal (firms' specific) governance mechanisms such as board, board size, debt and equity structure, efficient utilization of assets, informational efficiency, CEO and the chairman affect the value of a firm. The board performs an important function of monitoring the firms' management (Linck et al., 2008). It also plays a vital role in strategic decision making related to the firm and in controlling the actions of a CEO. The bigger board has higher level of expertise and makes better and realistic decisions by taking into account the available information (Coles et al., 2008). Furthermore, it is difficult for the CEO to dominate the bigger board and earn private benefits at an expense of shareholders' value.

Debt and equity structure has an important implication in affecting the value of a firm. Higher debt can reduce the free cash flow at the discretion of managers. Higher debt is only valuable in the presence of the concentrated shareholding (blockholders) as these blockholders act as a better debt monitor in the market. The concentrated shareholding is the hall-mark of the developing market which implies that higher debt in this market improves the value of a firm (Berglof, 1997).

In contrast to the positive role of the blockholders, there are additional imperfections in the developing market. These include inflation, rudimentary infrastructure, incomplete contracting, illiteracy,

lawlessness and corruption (Ahunwan, 2003). These factors reduce the complementary power of the blockholders to improve the marginal benefits of higher debt in this market.

There exists a dispersed shareholding in the developed market. This improves the marginal benefits of lower debt endorsing that a lower debt improves the value for shareholders in this market (Berglof, 1997).

Similar to the implications of the abovementioned instruments, efficient utilization of assets and informational efficiency play a pivotal role in implementing corporate governance. The efficient utilization of assets in the market leads to a lack of under and over utilization of the capital of a firm. This suggests that the value of a firm is improved as the resources are utilized optimally. Finally, the informational efficiency in the market represents the incorporation of public and private information in the share prices (Copeland et al., 2005). This reduces the information asymmetry and improves the firms' performance in the market.

Chief executive officer (CEO) heads the operations of a firm and makes strategic, operational and financial decisions. He serves as a monitor for other executives of an organization. CEO plays an important role in affecting the value of a firm by incorporating the corporate governance provisions in the firm (Rashid and Islam, 2008). The board of directors can hire and fire the CEO. The literature on corporate governance suggests that the turnover of a CEO has a negative relationship with shareholders' value as shareholders lose confidence in the firm. The CEO is hired on a short term contract (normally 3 years), which makes him concerned about the firms' performance during his own tenure. This short sightedness limits the shares to represent the true performance of a firm (Bhagat and Jefferis, 2002).

Similar to the CEO, the chairman holds a significant position in an organization. He heads all the committees and presides over the important meetings related to the issues in a firm. The chairman also monitors the performance of the CEO and plays a major role in renewing his contract (Kakabadse et al., 2006). He ensures the delegation of powers by the board to the executive management of a firm. Furthermore, the chairman enables the management to encourage the free flow of public and private information in a market. He should guide the board of directors to make critical decisions and maintain an optimal number of inside and outside directors in a board. Finally, the chairman should listen to shareholders' problems and provide an effective leadership to create value for them.

Hypothesis Development

CEO duality refers to the type of leadership structure in which a single person holds both the important positions of the CEO and the chairman in a firm. There are two theories related to the role of leadership structure in affecting the value of a firm. The first is agency theory and suggests that a single person keeping both these positions deteriorates the value of a firm as the independence of board is harmed (White and Ingrassia, 1992).

Furthermore, Fama and Jensen (1983) argue that dual leadership structure is favorable for the under-performing CEO as it makes difficult for the board to discipline a person who is also the chairman of a board. Dual leadership structure provides a negative impression to investors as this mode is against corporate governance principles. In dual leadership structure, agency cost between creditors and managers is not handled properly. This leadership structure also leads to a higher agency cost in the market making firms less attractive for investors (Rechner and Dalton, 1991). The corporate governance principles suggest that the CEO should be responsible for examining the policies of a company and monitoring the management of a firm. Similarly, the chairman should monitor and evaluate the performance of a CEO (Jensen, 1993: 36). The board members can also look after interests of the chairman in creating the value for shareholders.

The second is stewardship theory and suggests that managers' interests do not diverge with shareholders because they have acquired self actualization stage (Donaldson and Davis, 1994). Executive managers do not exploit shareholders and value job satisfaction and professional excellence for the advancement in their profession. Furthermore, these managers are less motivated by financial compared to the non financial incentives mentioned above. The executives of the firm (CEOs') are more concerned about their relationship with the employer and recognition at the workplace. The better performance of these executives will also enable them to reap future pension and other fringe benefits which make them inclined to improve the performance of a firm.

In case of dual leadership, the CEO being the chairman depicts a unified and solid impression as he is more knowledgeable about the operations of a firm (Lam and Lee, 2008). The speedy strategic and financial decisions by an independent CEO reduce the financial cost and improve the value of a firm. A single person performing both the tasks of executives (CEO and chairman) is cost effective as the firm pays salaries, bonuses and incentives to a single person.

The regulatory authorities can link the incentives to the CEO with his performance in dual leadership structure to safeguard the rights of shareholders (Bhagat and Jefferis, 2002). This will improve the value of a firm in developing and developed financial markets. The majority shareholders are better monitors of the management of a firm in the developing financial market (Kaplan and Minton, 1994). The independent CEO can be disciplined by the blockholders in this market. Similarly, the efficient regulatory authority can also make stringent regulations to control the actions of a CEO in the developed market. This discussion leads to the following hypothesis.

H1: CEO duality improves the value of a firm in the selected financial markets.

Conceptual Framework

Figure 1 (conceptual framework) suggests that the external governance instruments such as regulatory authority and blockholders can discipline the CEO in a market. This suggests a stewardship behavior of the CEO leading to the incorporation of corporate governance provisions in a firm.

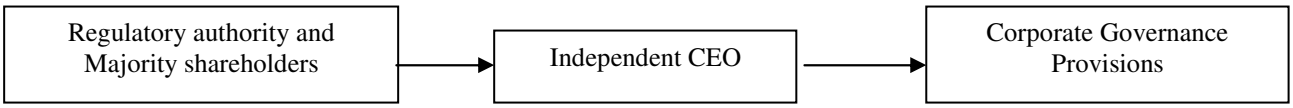

Figure 1. Conceptual framework for the study

Methodology

The data is collected for this study by using the secondary method of data collection. The variables in the model for the LSVF relationship consist of internal and external corporate governance instruments and control variables. The internal corporate governance instruments consist of a board size, CEO duality and the role of debt and equity structure. The external corporate governance instrument in this study is the role of judicial and regulatory authority efficiency in affecting the value of a firm. Finally, the control variables are price to book value ratio and return on total assets.

The data set for internal corporate governance instruments is collected from the OSIRIS database and is crossed checked against the information available at the websites of the individual firms. Furthermore, the data for the external regulatory regime is collected from the World Bank website. Finally, the data for control variables is collected from the books of Australian and Malaysian Securities Exchanges. The data collection was performed by using the stratified random sampling technique. This involves observing characteristics of the companies in the market by generalizing the properties of sample companies.

4.1 Variables for the Study

The first variable used in this study is the debt and equity (gearing) ratio. This variable shows us the amount of debt used in the firms of developing and developed financial markets. Due to the presence of additional imperfections in the developing market and absence of majority shareholders in the developed market, we expect a negative relationship between the higher debt and the value of a firm in these markets.

The second variable discussed in this section is the role of board size in affecting firms' value. The board size is measured by counting the number of directors on the board (Rashid and Islam, 2009). The positive relationship between the board size and the value of a firm shows that agency cost among the board members does not increase when an additional member joins the board. Furthermore, there are healthy divergences among the board members as they (board members) reduce the agency conflicts from the firm (Kyereboah-Coleman and Biekpe, 2005). We expect a positive relationship between the variable and the value of the firm in the selected markets.

The next variable used in the model for the LSVF relationship is the role of the CEO duality. The variable is measured by using the dummy variable (Lam and Lee, 2008). The value for the variable is 1 when a single person holds the positions of the CEO and the chairman. On the contrary, the value for the variable is 0 when these positions are distributed between the two separate persons. The relationship between dual leadership and the value of a firm is expected to be positive in the selected financial markets (Haniffa and Cooke, 2002).

The role of external corporate governance mechanism in the current study is tested by calculating the regulatory and judiciary index. The variable (log procedures) is constructed by taking into account the cost and time involved in the settlement of corporate disputes in a court. The higher value on the index shows an inefficient judicial and regulatory system leading to the poor performance of a firm. We expect a negative relationship between the regulatory index and the value of a firm in the selected markets (Bebchuk et al., 2004).

The control variables in this study are return on total assets and price to book value ratio. Return on total assets (ROTA) shows the efficiency of assets in creating shareholders' value. The variable is also used by Beiner and Schmid (2005) in their studies on corporate governance and the value of a firm (CGVF). ROTA is directly extracted from the financial statements of the listed firms in the selected markets. We expect a positive relationship between the value of a firm and return on total assets.

The second control variable used in this study is price to book value ratio (PBVR). The variable is calculated by dividing the current closing price of share by its book value. The higher value of the variable shows that market is informational efficient and investors are confident in making investments in firms. We expect a positive relationship between PBVR and the value of a firm in the selected markets.

The dependent variable used in this study is the proxy for Tobin's Q. This proxy is calculated by adding market capitalization and total assets. The shareholders' fund is subtracted from this added value. Finally, the obtained value is divided by total assets to get the proxy for Tobin's Q. Sarkar and Sarkar (2000) argue that it is difficult to find the replacement value for institutional debt in the developing financial system due to the market imperfections. This value is a better proxy for the firms' performance as the replacement value for institutional debt is not used in the formula for its calculation as used by previous researchers.

Table 1: Econometric Results for the Model

Variables	Combined Model
Constant	0.54 (3.09)**
Log Board Size	0.20 (1.25)
CEO Duality	0.14 (2.72)**
Gearing	-0.07 (-4.36)**
Price to Book Value Ratio	49.03 (13.56)**
Return on Total Assets	0.93 (1.78)*
Log Procedures	-0.15 (-2.31)**
R-squared	0.77
Adjusted R-squared	0.77
Mean Dependent Variable	1.42
F-statistic	(276.93)**

Notes: The values of the coefficients are in the first row.
Below are the values for T statistics in parenthesis.
Total number of observation for combined model = 480.
* Represents the significance of a variable at 10% significance level.
** Represents the significance of a variable at 5% significance level.
Source. Authors' estimates.

4.2 Multifactor Model

A multifactor model will be used in this study to test the role of CEO duality and other relevant variables in affecting the value of a firm. This model is presented as follows. Tobin's Q = f (CEO duality, board size, debt and equity ratio (Gr), regulatory authority efficiency (procedures), price to book value ratio and return on total assets).

The abovementioned model will enable us to suggest the relevance of business and management theories in explaining CEO duality and the value of a firm relationship in the selected markets.

Econometric Results

Models with alternate specifications and different functional forms are tried and the model with the best functional form and strong diagnostics is selected for the study (Gujarati, 2003). The selected model shows that 77% variation in the dependent variable is explained by the independent variables of the model. The 23% variation remains unexplained by these independent variables (price to book value ratio, return on total assets, CEO duality, board size, debt and equity structure and regulatory authority efficiency). The mean value for the dependent variable (Tobin's Q) is 1.42, which shows that firms of the selected markets are healthy and create value for shareholders. The value for the F statistic is 276.93 and is significant, which endorses the stability and reliability of the model (Maddala, 2001). The results are presented in Table 1.

The independent variables are also treated with the White Diagonal treatment to reduce heteroscedasticity (variable variance of the error term) in the selected model. In addition, the test to detect multicollinearity in the model for LSVF relationship was performed by calculating the variance inflation factor (VIF) for the individual independent variables. The values for the variance inflation factor range from 1.06 to 1.35 for gearing ratio and procedures (regulatory authority efficiency) respectively, confirming the absence of multicollinearity in the model. The results are presented in Table 2 below.

Table 2: Values for Variance Inflation Factor for Combined Markets

Variables	Variance Inflation Factor
Gearing	1.06
Procedures	1.35
CEO Duality	1.14
Return on Total Asset	1.19
Board Size	1.09
Price to Book Value Ratio	1.16

Source. Authors' estimates.

5.1 Incremental Regression

The test for incremental regression analysis was performed to confirm the importance of the independent variables in affecting the value of firm. This test was performed by removing the individual independent variables and capturing the decrease in the value for the R-squared. The removal of price to book value ratio (PBVR) has caused the highest change in the value for the R-squared as this value was reduced from 77% to 15%. The result shows that informational efficiency is the most important factor in affecting the value of a firm in the model. The result is presented in Table 3 below.

Table 3: Results of Incremental Regression

Models	Combined
R-squared (original)	0.77
R-squared (after the removal)	0.15

Source. Authors' estimates.

The importance of PBVR is also confirmed by the result of correlation analysis. Among all the variables of the model, price to book value ratio has highest correlation (0.87) with the value of a firm (Tobin's Q) which shows that informational efficiency is an important component in affecting the value of a firm in the selected markets. On the contrary, return on total assets has a lowest correlation with price to book value ratio (0.33) which shows that the optimal utilization of assets do not significantly improve the informational efficiency in these markets. These result are presented in Table 4 below.

Table 4: Factor Analysis: Results about the Highly Correlated Variables

Variables of Cross-market Analysis	Correlation Coefficient
PBVR and ROTA	0.33
TQ and AC	0.35
TQ and PB	0.87
MC and CF	0.49
AC and Log Pro	0.34

Source. Authors' estimates.

5.2 Explanation of Results

The result related to the role of CEO duality in affecting the firms' performance shows a positive relationship between dual leadership structure and the value of a firm. The result is significant at a 5% significance level with the value of coefficient as 0.14. This result suggests that the independent CEO improves the value of a firm by protecting the rights of shareholders, accepting our hypothesis (H1) for the study. The external regulatory regime in these markets is efficient which reduces the agency cost between shareholders and the CEO. The majority shareholders play a positive role by disciplining the independent CEO in the selected markets. Similarly, the regulatory control in the developed market pushes the CEO to make democratic decisions.

There is a lower level of agency cost due to lack of conflicts between the CEO and the chairman in these firms. The result shows that the CEO works as a steward due to his unique skills and adds value to shareholders in these markets (Donaldson and Davis (1991, 1994); Brickley et al. (1997); Haniffa and Cooke (2002) and Cornett et al. (2008)). The result also shows that keeping a single executive is cost effective for organizations of the selected markets.

The negative role of debt in affecting the value of a firm is endorsed at 5% significance level with the value of coefficient as -0.07. The result supports the findings by Rajan and Zingales (1995), Zwiebel (1996) and Chang and Mansor (2005) as higher debt in the selected markets does not improve shareholders' value by reducing the free cash flow problem. The result suggests that additional imperfections in the developing market reduce the complementary strength of the majority shareholders to improve the marginal benefits of higher debt in this market. Similarly, the absence of external monitors (blockholders) in the developed market nullifies the constructive role of debt due to the lack of imperfections in this market. These mechanisms are explanations about the negative relationship between the gearing ratio and the value of a firm in the selected markets.

There is a lack of significant relationship between the board size and the value of a firm in developing and developed markets.

The next relationship tested in this study is related to the role of regulatory authority in affecting the value of a firm. The result shows a negative (positive) relationship between an inefficient (efficient) regulatory authority and firms' performance. This finding shows that an efficient contract law improves the value of a firm by protecting shareholders' rights (Rashid and Islam, 2009). The result

proves that the effective regulatory authority adds to shareholders' benefits by lowering the monitoring cost paid by them in disciplining the management.

The result related to the role of price to book value ratio in affecting the value of a firm shows that the correct valuation of assets improves firms' performance at a 5% significance level with the value of coefficient as 49.03. This value is highest among the coefficients of all the variables showing its relative importance in the model.

The final result shows that there is a positive relationship between return on total assets and the value of a firm. This result endorses that the efficient and optimal utilization of assets improves firms' performance in the selected markets. These results are presented in Table 1.

Conclusion

The study has contributed in the literature by revisiting the leadership structure (CEO duality) and the value of a firm relationship in developing and developed markets by using a correct proxy to value a firm (Tobin's Q). The results of the study are interpreted by taking into account the characteristics of the selected markets and in the light of important business and management theories. The results suggest that an independent CEO works as a steward and improves the performance of a firm in these markets implying that there is a lack of agency cost between shareholders and the CEO in the selected markets. The firms of these markets should use dual leadership structure and relate the incentives for the CEO with the performance of a firm to further improve shareholders' value. Similarly, efficient regulatory framework reduces the information asymmetry in the selected markets. The regulatory control should be strengthened to further reduce the agency cost in these markets. On the contrary, higher debt deteriorates the value of a firm due to a poor management of conflicts between the creditors and managers in the selected markets. The results also show that the efficient utilization of assets and informational efficiency improve shareholders' value in these markets. The tests for incremental regression and correlation highlight the importance of informational efficiency in the selected markets. The limitation of the study suggests that the role of CEO duality in affecting shareholders' value in boom and recession in the economy can provide us with the different nature of relationship and with alternate policy implications.

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