CORPORATE OWNERSHIP & CONTROL

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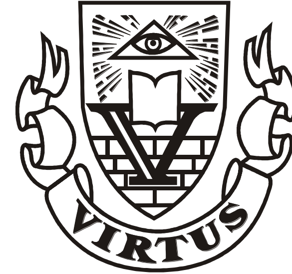

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CEO DUALITY AND FIRM PERFORMANCE: EVIDENCE FROM A DEVELOPING COUNTRY

Afzalur Rashid*

Abstract

This study examines if the CEO duality influences firm performance in Bangladesh. It also examines the interaction of industries in influencing the relationship between CEO duality and firm performance. From an observation of 825 firm years the study uses a 2-stage least square regression (2SLS) analysis. The finding is that there is a negative (non-significant) relationship between CEO duality and firm performance. However, when the industry interaction terms (the role of industries as moderating variable) are added, the CEO duality and firm performance is found to vary across industries. The findings of this study suggest that the CEO duality and firm performance is contingent; no single leadership structure is universal; both the leadership structure has cost and benefits. It is beneficial in some situation supporting the stewardship theory while it is not in other situations supporting the agency theory. This study contributes to the literature on CEO duality and firm performance in the context of developing countries.

Keywords: Agency Theory, Bangladesh, Board Chair, Board Leadership, CEO, Corporate Governance, Power, Stewardship Theory

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Introduction

There is a considerable debate in corporate governance literature on the role of board in disciplining the firm management, particularly the distribution of powers between the board Chair and Chief Executive Officer (CEO). Firms having one individual serving as both board Chair and CEO are considered to be the so called CEO duality. It is the situation in which the titles of both the board Chair and CEO go to one individual. In the words of Rechner and Dalton (1991: 155), it is "a board leadership structure in which the CEO wears two hats; one as the CEO of the firm, the other as chairman of the board of directors". Although there is a sacred and secret relationship between them (Kakabadse, *et al*, 2006), monitoring by the board depends on the distribution of power between the board Chair and the CEO (Pearce II and Zahra, 1991; Finkelstein and Hambrick, 1996). The professional integrity and trust to each other are the salient features that may influence the firm performance (Kakabadse *et al*, 2006).

The proponents of the dual board leadership structure (CEO duality) suggest that the CEO duality is required to enhance conformity and encourage firm performance (Tricker, 1994); it facilitates the faster respond to the hostile external conditions (Boyd, 1995); it is essential for strong firm leadership and power in managing the firm operations and to make quick decisions (Finkelstein and Hambrick, 1996). Dual leadership is a solution to external environmental challenges which has potential to increase firm performance (Kang and Zardkoohi, 2005). It allows combining firm specific knowledge and experience (Brickley *et al,* 1997). The corporation will have superior (improved) financial performance when CEO will have the full authority (Donaldson and Davis, 1991).

The proponents of CEO non-duality criticized such duality arguing that there is a problem of monitoring the management by the board if the board Chair and CEO is the same person. CEO duality gives enormous power to the CEO which tends to fail the internal control system (Jensen, 1993; Goyal and Park, 2002); reduces the check and balances as CEO may be motivated by self-interest ignoring the interest of the various other stakeholders (Tricker, 1994). Such a powerful CEO can influence the board activities by forming board committees in pursuant to his personal interest and manipulate the board meetings by not raising an important agenda. The CEO may not want a capable board as the capable board may challenge their power and authority (Zahra, 1990). CEO duality makes it difficult for the board to remove poorly performing managers (Goyal and Park, 2002), rather with their power, the CEO dominated board may select, reward or replace a director. CEO duality reduces the firm performance due to CEO entrenchment and a decline in board independence (Kang and Zardkoohi, 2005). It is also argued that the CEO can not represent the shareholders and the management at the same time (Rechner and Dalton, 1991). Duality promotes the

CEO entrenchment (Finkelstein and D'Aveni, 1994). CEO duality is detrimental to the firm performance as the same person will be marking his/ her "own examination paper" (Wan and Ong, 2005: 278). In the words Abdullah (2004) 'who will watch the watchers?' or in the words of Alchian and Demsetz (1992) ‘who monitors the monitor?’ Separating the position of CEO and board Chair reduces the CEO and inside directors to exercise the opportunistic behavior which will in turn allow the board to better exercise its control (Daily and Dalton, 1994a).

Despite such debate it is still a puzzle whether the independent leadership structure will enhance the board effectiveness that may ultimately lead to better firm performance. There is no significant impact of CEO duality on firm performance (Baliga *et al,* 1996). There is no optimal board leadership structure; both form of leadership structure may have potential costs, as well as benefits (Boyd, 1995; Brickley *et al*, 1997; Mak and Li, 2001; Elsayed, 2007). Kang and Zardkoohi (2005) suggest that CEO duality is contingent and there are five antecedents of CEO duality, such as (1) duality as a reward for CEO’s good performance, (2) duality is a solution to the environmental resource-scarcity, complexity and dynamism, (3) duality is conforming to institutional pressure, (4) duality is a result of social exchange reciprocity and (5) duality is imposed by powerful CEO. Kang and Zardkoohi (2005) further argue that, leadership structure has no particular advantages for shareholders; when CEO imposes duality to entrench his/her power, there will be a negative impact on firm performance and when board adopts the duality to provide strong leadership and to increase the speed of strategic decision making, there will be positive impact on firm performance. Enron, Tyco International, and Xerox had a CEO duality and CEO also served as board Chair of the board (Kholeif, 2008), while both WorldCom and Global Crossing separated the positions of CEO and board Chair; although, the role of board Chair was a powerful position within these firms, the holder of this position did not have the ability to control corporate wrongdoings within these firms (Petra, 2005).

Over the past few decades an overwhelming proportion of research on CEO duality is conducted in the context of developed economies with sophisticated financial and legal systems except a handful studies on less developed and emerging economy. Given the increased attention on CEO duality and its impact on firm performance and considering Bangladesh as an emerging economy, this study examines if the CEO duality influences the firm economic performance in Bangladesh. Although the CEO duality is very common in the Bangladesh corporate sector, ironically there is no published study on CEO duality and firm performance in Bangladesh. The key motivation of this study is to explore if the dual leadership structure works well in a developing country, such as Bangladesh. This study is similar to the paper by Elsayed (2007) in the context of Egypt. However, this study differs from that paper in terms of institutional context and in terms of research methods. Doidge *et al* (2007) argue that due to differences in institutional settings, corporate governance practices may vary widely across countries and across firms. Unlike Egypt, the recent corporate governance regulation in Bangladesh requires the clear differentiation between the executive and non-executive (independent) directors. In terms of research method, the sample size of this study is relatively large and it used the 2 Stage Last Square Regressions. This study may contribute to the literature and ongoing debate of CEO duality and firm performance.

The remainder of the paper is organized as follows. Section two presents the background literature of this study. Section two presents the institutional background of CEO duality in Bangladesh. Section three presents the earlier studies on CEO duality. Section four presents the 'theoretical rationale' and presents the hypothesis. Section five presents the methodological issues. The section six presents the empirical findings. The final section makes the discussion and draws a conclusion.

INSTITUTIONAL BACKGROUND OF CEO DUALITY IN BANGLADESH

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, such as Finland, Germany, Holland and the Netherlands (Tricker, 1994; Maassen, 2002). In such a board, the management functions of the board mostly oversee the operational issues and headed by Chief Executive Officer (CEO) and supervisory functions of the board deals with the strategic decisions and oversee the management function of the board headed by Chairperson as non-executive director (Solomon, 2007). 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 CEO duality, which combines the executive function of the board with monitoring function, is commonly found in the one-tier board, which is most common in Anglo-Saxon or Anglo-American countries, such as the United States, the United Kingdom and Canada, Australia, New Zealand, both the executive and the non-executive directors perform duties together in one organizational layer. In such a board there may be any combination of executive and non-executive directors (Maassen, 2002; Solomon, 2007; van Veen and Elbertson, 2008).

Unlike the corporate boards in continental Europe, traditionally[1] the corporate board in

Bangladesh is a one-tier board or management board; both the executive and the non-executive directors perform duties together in one organizational layer. Further, in most of the companies in Bangladesh, board is heavily dominated by the sponsor-shareholders who generally belong to one family-the father as the chairperson and the son as the CEO (Sobhan and Werner, 2003); the CEOs are the representative of the sponsor-shareholders, family members of the sponsor-shareholders. Their qualification and expertise does not always prevail in appointing them into the firm. Due to huge dominance of family on the corporate board it is very difficult to separate these two functions. Therefore, there are many incidences of CEO duality in Bangladesh corporate sector. Sometimes the largest shareholder acts a board Chair and imposes the duality (also acts as CEO). The recent corporate governance regulation[2] requires a board size of be 5-20 members, an independent director in the board (at least 1/10th of the total board members or minimum one). However, it does not compulsorily require the structural independence (or CEO non-duality). It also leads to some incidences of CEO duality in some listed companies. Furthermore, structural independence does not always prevail the organizational or industry practice.

EARLIER STUDIES ON CEO DUALITY

Due to huge debate and controversy on CEO duality and its impact on corporate performance there is comparatively a large number of empirical studies. The evidence is mixed and non-conclusive. Some studies found a significant positive relationship between CEO duality and firm performance implying that combined leadership structure (CEO duality) is associated with better firm performance than those with independent leadership structure (CEO non-duality) supporting the stewardship theory (such as Davidson *et al,* 1990; Donaldson and Davis, 1991; Finkelstein and D'Aveni, 1994; Boyd *et al,* 1997; Brickley *et al*, 1997; Sridharan and Marsinko, 1997; Coles *et al,* 2001; Tian and Lau, 2001; Lin, 2005). In sharp contrast, another set of studies found a significant negative relationship between CEO duality and firm performance implying that combined leadership structure (CEO duality) is not beneficial for performance supporting the agency theory (such as Berg and Smith, 1978; Rechner and Dalton, 1991; Pi and Timme, 1993; Daily and Dalton, 1994b; Daily and Dalton, 1994c; Daily and Dalton, 1995; Worrell *et al,* 1997; Simpson and Gleason, 1999; Kula, 2005). The other studies found a non significant relationship (no correlation) between CEO duality and firm performance (such as Chaganti *et al,* 1985; Rechner and Dalton, 1989; Daily and Dalton, 1992; Daily and Dalton, 1993; Daily and Dalton, 1994a; Baliga *et al,* 1996; Daily and Dalton, 1997; Dalton *et al,* 1998; Harris and Helfat, 1998; Fosberg, 1999; Judge *et al,* 2003; Abdullah, 2004; Wan and Ong, 2005; Braun and Sharma, 2007; Elsayed, 2007; Lam and Lee, 2007; Iyengar and Zampelli, 2009). Furthermore, there are numerous studies (such as Boyd, 1995; Donaldson and Davis, 1991; Brickley *et al*, 1997; Elasyed, 2007) which attempted to explore the industry specific impact of CEO duality and firm performance suggesting that CEO duality and firm performance are contingent and varies across industries. The earlier studies can be criticized on the premise that many of the earlier studies have shown inconsistent results; nearly all the research did not control for industry influence or other corporate governance mechanisms as moderating variables.

THEORITICAL RATIONALE AND HYPOTHESIS DEVELOPMENT

There are two extreme theoretical underpinnings so far seen in the literature in explaining the CEO duality and firm performance. These are agency theory (such as Fama, 1980; Jensen and Meckling, 1976; Eisenhardt, 1989) and stewardship theory (such as Davis *et al*, 1997).

Agency theorists argue that there is an inevitable conflict between the parties, such as principals and agents. This theory assumes that an individual is self-interested and self-opportunist, rather than altruistic. Consistent with this view CEO duality (the combined leadership structure) leads to the consolidation of power and authority which may promote CEO entrenchment by weakening or reducing the monitoring effectiveness of the board (Solomon, 2007). Such a powerful CEO 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 principals (Deegan, 2006). "CEO duality diminishes the monitoring role of the board of directors over the executive manager, and this in turn may have a negative effect on corporate performance" (Elsayed, 2007: 1204). Therefore, agency theory suggests a negative relationship between CEO duality and firm performance (Boyd, 1995).

In sharp contrast stewardship theory holds an optimistic view of human (managerial behavior) arguing that the agents are not necessarily motivated by individual goals, 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). Consistent with this view, stewardship theorist suggests the consolidation of power of the executives. In other words the best stewardship role by the CEO can only be exercised only when the role of the CEO and Chair of the board is combined, (Donaldson and Davis, 1991; Ong and Lee, 2000). Therefore, stewardship theory suggests a positive relationship between CEO duality and firm performance (Boyd, 1995).

This study considers that due to the separation of ownership and control, the agent may be driven by self-interest. Therefore, this study is conducted within the *'agency theory'* perspective arguing essentially that the CEO duality will reduce the firm performance. Hence the following hypothesis is offered in the null form:

Hypothesis 1: *CEO duality is negatively related to firm performance.*

METHODOLOGICAL ISSUES

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 as on that date. The sample also consists of variety of industries as per the classification of 'Standardized Industrial Classification' (SIC) Code (table 2). Dependant upon the availability of company annual reports, a total of 825 observations was made.

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.

Year	Number of firms in the sample	Observed firm years
2000	93	92
2001	93	93
2002	93	93
2003	93	93
2004	93	93
2005	93	93
2006	93	93
2007	93	91
2008	93	78
2009	93	6
Total		825

The categorization of the sample reveals that there is approximately 47.52 percent incidence of CEO duality. This percent is closer to earlier research, such ah as Braun and Sharma (2007) which reported 55% of duality incidence. This figure is higher than Japanese, United Kingdom, Italian and Belgian Companies as firms in these countries only have 10-20 percent CEO duality (Kang and Zardkoohi, 2005). However, this figure is lower than that of U. S. firms as firms in these countries have 75-80 percent CEO duality (Rechner and Dalton, 1991; Donaldson and Davis, 1991; Brickley *et al*, 1997; Kang and Zardkoohi, 2005). Even this figure is fairly lower than that of Egypt which has almost 80 percent CEO duality (Elsayed, 2007; Kholeif, 2008).

Table 2. Industry classification of the sample

Year	Number of firms in the sample	Observed firm years
Agricultural Production-Corps	12	105
Agricultural Production-Livestock	1	9
Fishing, Hunting and Trapping	3	25
Non-Metallic Minerals, Except Fuels	1	9
Food and Kindred Products	1	9
Textile Mill Products	30	265
Paper and Allied Products	2	18
Printing and Allied Products	1	9
Chemicals and Allied Product	18	161
Petroleum and Coal Products	2	17
Leather and Leather Products	4	37
Stone, Clay and Glass Products	4	36
Primary Metal Industries	2	18

Electronic and Other Electric Equipment	4	36
Miscellaneous Manufacturing Industries	3	27
Automotive Dealers and Service Station	2	19
Real Estate	2	16
Holding and Other Investment Offices	1	9
Total	93	825

Table 3. Incidence of CEO Duality in the sample

Number of firms in the sample	Incidence of CEO Duality	Incidence of CEO Non-Duality	Observed firm years
93	392	433	825

Variable Definitions

Dependent Variable: Firm Performance

There are two performance measures so far seen in corporate governance literature. One group used the accounting performance measure such as profit margin or Return on Sales (Rechner and Dalton, 1989; Abdullah, 2004), Return on Assets (Rechner and Dalton, 1991; Daily and Dalton, 1992; Daily and Dalton, 1993; Pi and Timme, 1993; Daily and Dalton, 1994c; Boyd, 1995; Boyd *et al*, 1997; Tian and Lau, 2001; Abdullah, 2004; Elsayed, 2007; Lam and Lee, 2008; Elsayed, 2009; Kholeif, 2008), Return on Equity (Berg and Smith, 1978; Donaldson and Davis, 1991; Rechner and Dalton, 1991; Daily and Dalton, 1992; Daily and Dalton, 1993; Baliga *et al,* 1996; Fosberg, 1999; Tian and Lau, 2001; Abdullah, 2004; Lam and Lee, 2007; Kholeif, 2008; Elsayed, 2009), Earnings per Share (EPS) or Price Earnings Ratio (Daily and Dalton, 1992; Daily and Dalton, 1993; Daily and Dalton, 1994c; Abdullah, 2004), stockholders return (Rechner and Dalton, 1989), corporate bankruptcy (Chaganti *et al,* 1985; Daily and Dalton, 1994a; Daily and Dalton, 1994b; Daily and Dalton, 1995) and financial distress (Simpson and Gleason, 1999). The other group used the market based performance measure, such as Tobin's Q (Elsayed, 2007; Elsayed, 2009) and Shareholder's Wealth (Donaldson and Davis, 1991).

Both the performance measures have merits and demerits. Accounting performance measures (1) are subject to manipulation; (2) may systematically undervalue assets; (3) financial accounting returns are difficult to interpret in the case of multi-industry participation by firms (Dalton *et al,* 1998). Such measures may not reflect the all agency costs (Wiwattanakantang, 2001: 334); may give misleading signals (Kaplan and Norton, 1992). In order to apply stock market performance, the stock prices must reflect the true value of the firm (Lindenberg and Ross, 1981). In a similar vein, stock market performance may not be effective in some developing and emerging economies as the capital market in those countries is not well developed and inefficient (Lindenberg and Ross, 1981; Khanna and Palepu, 1999; Joh, 2003).

Keeping this in mind this study uses both the Return on Assets (ROA) and Tobin's Q as firm performance measures (dependent variable). Consistent with Yammeesri and Lodh (2004), Yammeesri *et al* (2006), Rashid and Lodh (2008), Return on Assets (ROA) is calculated as the Earnings before Interest and Taxes (EBIT) scaled by the book value of total assets. Tobin's Q is the ratio of the market value of the firm to the replacement cost of their assets.

Independent Variable: CEO Duality

The CEO duality is the situation when the chair of the board and the CEO or Managing Director holds the same position. Consistent with earlier studies, the 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).

Control Variables

A number of control variables, such as board size, ownership structure, debt ratio, firm size, firm age and firm growths are considered. Board size has number of implications for board functioning and thereby firm performance (Raheja, 2005; Coles *et al,* 2008; Bennedsen *et al,* 2008). 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). "Larger boards were assumed to have directors with diverse educational and industrial backgrounds and skill and with multiple perspectives that improves the quality of action taken by the firm…………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: 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). Ownership structure plays a key role as a good monitor in countries where the investor's protection is weak (Shleifer and Vishny, 1997; La Porta *et al*, 1998; La Porta *et al*, 2000; Boubakri *et al*, 2005). CEO duality with the presence of managerial ownership may align the interest of CEO with that of shareholders (Barnhart and Rosenstein, 1998; Kholeif, 2008). Elsayed (2007: 8) argues that, "board leadership structure and managerial ownership can be considered as substitutive corporate governance mechanisms". Institutional investors also have a professional interest in developing the firm's corporate governance (Nandelstadh and Rosenberg, 2003), and can identify key indicators in determining performance in the emerging market. This is because they prefer to work inside the firms to change policies of firms in their portfolio (Baysinger and Butler, 1985: 107; Gibson, 2003). 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 Kula (2005), Elsayed (2007) and Kholeif (2008), this study also considers directors (DIROWN) and institutions (INSTOWN) ownership as the control variable 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). This study considers the control variable debt to identify the impact of debt 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.

EMPIRICAL ANALYSIS

Descriptive Statistics

The descriptive statistics of the variables are presented in table 4. It reveals that on an average there is a 47 percent incidence of CEO duality. The average board size is 6.19 ranging from minimum 3 directors to maximum 12 directors. The average director ownership is 43 percent ranging from 0 to 98 percent. The average institutional ownership is 18 percent which ranges from 0 to 58 percent. The average debt ratio is 73 percent ranging from 2 percent to 562 percent. The average firm age in the sample is 14.15 years, ranging from less than 2 year to 32 years. The mean profitability control variable for Return on Asset (ROA) is 6 percent, ranging from negative 149 percent to 34 percent. The mean profitability control variable for Tobin's Q is 117 percent ranging from 17 percent 623 percent.

Table 4. Descriptive statistics of the variables (N=825)

Variables	Mean	Minimum	Maximum	Std. Deviation	Skewness	Kurtosis
Return on Assets (ROA)	0.06	-1.49	0.34	0.10	-5.32	82.27
Tobin's Q	1.17	0.17	6.23	0.65	2.54	9.99
CEO duality	0.47	0.00	1.00	0.50	0.10	-1.20
Board Size (BDSIZE)	6.19	3.00	12.00	1.91	0.55	-0.24
Director Share Ownership (DIROWN)	0.43	0.00	0.98	0.17	-0.09	0.75
Institutional Share Ownership (INSTOWN)	0.18	0.00	0.58	0.16	0.49	-0.84
Debt Ratio (DEBT)	0.73	0.02	5.62	0.53	3.57	20.19
Firm Age (AGE)	14.15	2.00	32.00	1.55	-0.62	0.27
Firm Size (SIZE)	5.98	2.44	9.87	1.49	-0.05	-0.24
GROWTH	0.24	-1.00	104.33	3.69	27.36	771.03

For performing statistical analysis, there is a necessity to meet the assumptions of statistical analysis, such as normality, heteroscedasticity and multicolinearity. Coakes and Steed (2001) argue that the violations of normality are of little concern, when the sample size is large (greater than 30). The skewness and kurtosis from the descriptive statistics above reveal that most of the variables are normally distributed and there are minimum violations of normality. Further, the P-P plots of all the variables show a little deviation from the fitted lines and Q-Q plots form a 45 degree line for all variables, implying

that the normality assumption is not violated. Finally, Shapiro-Wilk statistic does not reject the null hypothesis of normality ($p < 0.001$). Also, the descriptive statistics do not reveal any sign of heteroscedasticity in the sample data.

Multicolinearity refers to high correlations among the independent (or explanatory) variables or it is a condition when the independent variables are significantly correlated with one another. When the high degree of correlation is found among the independent variables, these variables must be removed. The SPSS automatically removes the independent variable which is significantly correlated with other independent variables in OLS regression and indicates the regression model to be invalid under 2SLS regression. No such problems were seen in this analysis. Further, the correlation matrix of the explanatory variables (in table 6) shows that there is no strong correlation between the variables as correlation coefficients are very small (less than 0.75 or negative) and Variance Inflation Factor (VIF) is less than 10 (Gujarati, 2003). Therefore all the variables can be considered for the analysis.

Regression Model Specification

In order to examine the relationship between CEO duality and firm performance, the following model is developed:

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

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*, $BDSIZE_{i,t}$ is the board size 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*, $TDTA_{i,t}$ is the 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. The above model is regressed by using 'The Statistical Package for Social Science' (SPSS). In this analysis, no endogeneity problem occurred as 2SLS regression is used by using instrumental control variables which have automatically eradicated such a problem. The problem of endogeneity may be relevant if the parameters are estimated by using an OLS (Ordinary Least Square) regression in the context of time series analysis. In this study, the data is pooled for nine (9) year period from different organizations and, therefore, this problem is not applicable.

Empirical Results

Table 5 presents the 2SLS regression analysis of the relationship between the CEO duality and corporate performance (such as ROA and Tobin's Q). The Adjusted R squared and F-statistic being significant ($F < 0.001$) indicates the model is overall fit. The result indicates that there is a negative (but not significant) relationship between CEO duality and firm performance under ROA performance measure. However, there is a significant negative relationship (although it is very weak, the coefficient is only 0.099) between CEO duality and the firm performance under Tobin's' Q. Therefore, there is an ample evidence to support the hypothesis.

The result also indicates that 'board size' and 'director ownership' have significant positive explanatory power in influencing firm performance under all the performance measures. Institutional ownership has significant negative explanatory power in influencing firm performance under Tobin's Q. Debt has significant negative explanatory power in influencing firm performance under ROA performance measure; whereas it has significant positive explanatory power in influencing firm performance under Tobin's Q performance measure. Other control variables, such as firm age and firm size have significant positive explanatory power under all the performance measures.

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

	Dependent Variables			
	(a)		(b)	
	ROA		**Tobin's Q**	
Intercept	-0.046		-1.018	***
	(-1.639)		(-7.038)	
CEOD	-0.002		-0.099	**
	(-0.313)		(-3.046)	
BDSIZE	0.032	**	0.365	***
	(3.091)		(6.960)	
DIROWN	0.058	**	0.178	*
	(3.163)		(1.882)	
INSTOWN	0.011		-0.203	*
	(0.547)		(-1.960)	
Debt	-0.069	***	0.811	***

	(-11.300)		(25.853)	
AGE	0.014	*	0.302	***
	(1.937)		(8.114)	
SIZE	0.006	**	0.025	**
	(2.713)		(2.172)	
Adjusted R^2	0.193		0.541	
GROWTH	0.000		-0.003	
	(-0.386)		(-0.584)	
F-Statistic	**25.554**	***	**121.909**	***
Observations	**825**		**825**	

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

The ROA model of this study confirms the earlier studies (such as Chaganti *et al,* 1985; Rechner and Dalton, 1989; Daily and Dalton, 1992; Daily and Dalton, 1993; Daily and Dalton, 1994a; Baliga *et al,* 1996; Dalton *et al,* 1998; Harris and Helfat, 1998; Fosberg, 1999; Judge *et al,* 2003; Abdullah, 2004; Elsayed, 2007) implying that CEO duality has no influence on firm performance. The Tobin's Q model of this study confirms the earlier studies (such as Rechner and Dalton, 1991; Pi and Timme, 1993; Daily and Dalton, 1994b; Daily and Dalton, 1994c; Daily and Dalton, 1995; Worrell *et al,* 1997; Simpson and Gleason, 1999; Kula, 2005) implying that there is a significant negative relationship between CEO duality and firm performance.

Table 6. CEO duality and firm performance: Correlation matrix of the explanatory variables

		1	2	3	4	5	6	7	8	VIF
1	**CEOD**	1.000								1.103
2	**BDSIZE**	0.025	1.000							1.124
3	**DIROWN**	-0.116	-0.023	1.000						1.142
4	**INSTOWN**	0.093	-0.037	0.295	1.000					1.133
5	**Debt**	-0.074	-0.091	0.031	0.051	1.000				1.151
6	**AGE**	0.200	-0.180	-0.063	0.033	-0.103	1.000			1.096
7	**SIZE**	0.081	-0.265	0.091	-0.022	0.327	0.016	1.000		1.237
8	**GROWTH**	-0.043	-0.011	-0.009	0.012	0.007	-0.020	0.019	1.000	1.003

Many prior studies (such as Boyd, 1995; Dalton *et al,* 1998; Worrell *et al,* 1997; Kang and Zardkoohi, 2005; Braun and Sharma, 2007; Lam and Lee, 2008; Kholeif, 2008; Elsayed, 2009; 2010) argue that, duality may be negatively related to performance in some situations but may be positively related in some other situations. Further, "the appropriate board leadership structure is more likely to vary across firms, industries and countries" (Elsayed, 2010: 2). There is 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). Following this argument and consistent with Boyd (1995), Sridharan and Marsinko (1997), Dahya and Travlos (2000), Donaldson and Davis (1991), Elsayed (2007) this study further examines the industry specific impact on CEO duality and firm performance. The above model is modified by adding industry dummies for two-digit industrial classification (SIC) codes. Table 7 presents the regression coefficients of the relationship between the CEO duality and corporate performance (both for ROA and Tobin's Q model) following the control of the models by industry dummies.

Table 7. Influence of industry on CEO duality and firm performance under different performance measures

	Number of firms	Observed firm years	Percent of CEO duality	(a) ROA		(b) Tobin's Q	
Agricultural Production-Corps	12	105	50.00	0.034 (3.190)	**	0.149 (2.824)	**
Agricultural Production-Livestock	1	9	88.89	-0.042 (-2.760)	**	-0.019 (-0.253)	
Fishing, Hunting and Trapping	3	25	74.29	-0.003 (-1.542)		0.003 (0.285)	
Non-Metallic Minerals, Except Fuels	1	9	00.00	0.004 (1.863)	*	0.006 (0.556)	
Food and Kindred Products	1	9	00.00	-0.005 (-3.266)	**	-0.012 (-1.713)	*
Textile Mill Products	30	265	57.19	0.030 (2.500)	*	-0.026 (-1.526)	
Paper and Allied Products	2	18	00.00	0.002 (2.389)	*	0.000 (0.095)	
Printing and Allied Products	1	9	00.00	0.003 (2.233)	*	0.007 (1.199)	
Chemicals and Allied Product	18	161	36.65	0.002 (4.894)	***	0.013 (8.310)	***
Petroleum and Coal Products	2	17	00.00	0.001 (1.489)		0.022 (5.792)	***
Leather and Leather Products	4	37	00.00	0.002 (4.204)	***	0.008 (3.468)	**
Stone, Clay and Glass Products	4	36	55.56	0.001 (1.857)	*	0.010 (4.058)	***
Primary Metal Industries	2	18	50.00	-0.001 (-1.779)	*	0.004 (1.425)	
Electronic and Other Electric Equipment	4	36	58.33	0.001 (2.881)	**	0.018 (8.513)	***
Miscellaneous Manufacturing Industries	3	27	96.29	0.000 (-.8700)		0.004 (1.896)	*
Automotive Dealers and Service Station	2	19	73.68	0.001 (2.832)	**	0.006 (3.141)	**
Real Estate	2	16	50.00	0.000 (-1.266)		-0.001 (-0.818)	
Holding and Other Investment Offices	1	9	100.00	0.000 (-0.709)		0.007 (3.256)	**
Total	**93**	**825**					

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

The results suggest that, CEO duality most frequently occurs in the industries, such as Agricultural Production-Livestock, Fishing, Hunting and Trapping, Electronic and Other Electric Equipment, Miscellaneous Manufacturing Industries, Automotive Dealers and Service Station and Holding and Other Investment Offices. CEO non-duality most frequently occurs in the industries, such as Non-Metallic Minerals, Except Fuels, Food and Kindred Products, Paper and Allied Products, Printing and Allied Products, Petroleum and Coal Products and Leather and Leather Products.

The CEO duality is positively related under both the performance measures in six (6) industries: Agricultural Production-Corps; Chemicals and Allied Product; Leather and Leather Products; Stone, Clay and Glass Products; Electronic and Other Electric Equipment and Automotive Dealers and Service Station. The CEO duality is negatively related under both the performance in one (1) industry: Food and Kindred Products. The CEO duality is positively related under ROA performance measures in three (3) industries: Textile Mill Products; Paper and Allied Products and Printing and Allied Products. The CEO duality is positively related under Tobin's Q performance measures in three (3) industries: Petroleum and Coal Products; Miscellaneous Manufacturing Industries and Holding and Other

Investment Offices. CEO duality does not influence firm performance under any performance in two (2) industries: Fishing, Hunting and Trapping and Real Estate.

DISCUSSION AND CONCLUSION

This study investigated if the CEO duality influences firm performance in Bangladesh. It also examined the interaction of industries in influencing the relationship between CEO duality and firm performance. The finding is that there is a non-significant negative relationship between CEO duality and firm performance under accounting performance measure and significant negative relationship under market performance measure. Although much needs to be explored on CEO duality and firm performance, the finding of this study implies that independent leadership structure (CEO non-duality) is beneficial for firm economic performance in Bangladesh. The dual leadership structure reduces the board's ability to exercise the governance function in the context of Bangladesh supporting the agency theory.

Further, the interaction terms of the industry dummies reveal that CEO duality and firm performance vary across industries. This is consistent with the argument that the CEO duality is not a random phenomenon (Kang and Zardkoohi, 2005); it varies across firms depending on the industry specific characteristics (Boyd, 1995; Brickley *et al,* 1997; Dahya and Travlos, 2000; Mak and Li, 2001; Elsayed, 2007). Although CEO duality "has been blamed for poor performance and slow response to change in firms such as General Motors, Digital Equipment Corporate and Goodyear Tire and Rubber" (Boyd, 1995: 301) or some of the CEOs are found to be in involved in corporate malpractice that led to the corporate scandals in USA, it does not necessarily mean that CEO duality is a bad governance structure (Kang and Zardkoohi, 2005). The cost and benefits of different leadership structures may vary across firms or industry (Brickley *et al*, 1997; Mak and Li, 2001; Elsayed, 2007) or "because the practice is prevalent in the industry" (Kang and Zardkoohi, 2005, 794). CEO duality is good for some firms, while it is opposite for other firms (Boyd, 1995; Brickley *et al*, 1997; Elsayed, 2007); "a particular firm may adopt CEO duality under an appropriate or inappropriate organizational condition" (Kang and Zardkoohi, 2005: 786).

The theoretical implication of this study is that CEO duality and firm performance is contingent; no single leadership structure is universal; both the leadership structure has cost and benefits. It is beneficial in some situation supporting the stewardship theory while it is not in other situations supporting the agency theory.

This study may have some limitations. Such as, the data were 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 agency theory (or stewardship, which is in fact opposite to agency theory) perspective. As Bangladesh enacted the corporate governance best practices (Corporate Governance Notification) which requires independent directors to be appointed in the board. Therefore, further study may be conducted on CEO duality on firm performance by controlling the duality for other corporate governance effect, such as outside independent directors. The theoretical foundation such study may be the 'resource dependence theory' arguing 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).

Notes

[1] This is also due to common law tradition of the country (as opposed to civil law); Bangladesh is a common law country. The two-tier board is common in civil law countries (Rose, 2005).

[2] The regulatory body Securities and Exchange Commission Bangladesh announced the "Corporate Governance Notification 2006". Although it is based on comply or explain basis, it is considered as the corporate governance best practices for the listed firms in Bangladesh.

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TOWARDS DEVELOPING GUIDING PRINCIPLES FOR MANAGING OPERATIONAL RISK APPETITE

J. Young*

Abstract

Within the context of operational risk management, the understanding of the term operational risk appetite is still vague and not fully implemented by organisations to take advantage of the potential benefits thereof. This study analyses various definitions which serve as a platform for formulating guiding principles in order to manage operational risk appetite. To confirm the applicability and importance of these guidelines they were empirically tested in the banking industry in South Africa. The research indicates that the proposed guiding principles for managing operational risk are valid and that their adoption could lead to potential benefits for a banking organisation. While it is recommended that banks adopt these principles to experience the advantages of managing its operational risk appetite, other corporate organisations may also encounter similar benefits.

Keywords: Risk appetite, Risk tolerance, Operational risk, Key risk indicators, Risk and control self-assessments, Risk financing, Risk control, Risk identification, Risk evaluation, Risk monitoring, Risk capacity, Risk acceptance

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1. Introduction

The concept of *risk appetite* is a phenomenon of the modern risk management approach. Since 2000, much has been written on the subject of risk appetite by various role players, for example the Basel Committee on Banking Supervision or BCBS (2006), Nocco and Stultz (2006), Chapman (2008) and Segal (2006). A variety of different views and opinions have been formed, and terms such as *risk capacity*, *acceptable risk* and *risk tolerance* have been used. The variety of terminology has resulted in some confusion on the exact meaning of risk appetite. In order to eliminate some of the confusion, it is necessary to converge certain of these views and opinions.

An organisation's risk management policy should stipulate its approach to and its appetite for risk. However, this is not as straightforward as it sounds. One reason, for example, is the lack of a clear and acceptable definition of risk appetite. According to Carey (2005), risk appetite is a term that is frequently used throughout the risk management community, but it seems that there is a lack of useful information on its application outside of financial risk areas or other risks that can easily be translated into financial terms.

Because there are various primary risks an organisation could encounter, such as credit risk, market risk, liquidity risk and operational risk, and because each risk should be managed by means of its own management methodologies, this article will concentrate on operational risk. The focus will therefore be to clarify the concept of risk appetite as it refers to operational risk only, and to illustrate that managing the operational risk appetite is an opportunity rather than a threat.

The primary purpose of the study on which this article is based, was to evaluate various definitions of risk appetite and to identify specific terms which could assist in formulating guiding principles for managing operational risk appetite. However, before assessing the various definitions, it is important to demarcate the subject of operational risk management as a management process. After formulating the guiding principles, it is imperative to discuss the role and responsibilities of the board of directors as it relates to the management of risk appetite. According to Mongiardino and Geny (2007), in the area of risk governance, a clear description of the role of the board of directors and its committees in setting the risk appetite for the organisation is required.

There are a variety of benefits which an organisation can experience by following the guiding principles for managing its operational risk appetite which will be identified in the article.

A report on an empirical study, based on the banking industry in South Africa, will conclude this article. A survey to determine the status of the understanding and implementation of operational risk

as a separate risk management discipline was conducted. The potential use of the formulated guiding principles and benefits an organisation could experience when implementing these guidelines will be assessed.

The following section reviews the relevant literature on operational risk and risk appetite. This will be followed by the empirical study.

2. Operational risk

In order to be able to lead a discussion on operational risk appetite, it is necessary to understand the concept of operational risk. Therefore, this section deals with a discussion on the concept of operational risk and the components of a typical management process. There are various tools available for managing operational risk so as to determine the operational risk appetite. These tools are briefly referred to in this section. Furthermore, the role of top management forms an important part of operational risk management, which is explained in more detail, especially the way it relates to operational risk appetite.

Operational risk is a concept that has been around for many years; for example, during the wars of the Roman Empire risks were identified and addressed in order to protect the soldiers. When the soldiers stormed the castles, the defending force poured boiling tar on the attackers. This was anticipated and the soldiers protected themselves with wooden shields. This is a typical example of managing risk exposure.

However, in 1995 operational risk became a focus point for many businesses, with the banking industry leading. This was due to one individual (Nick Leeson) who was responsible for the downfall of Barings Bank, one of the UK's largest and oldest banks. Leeson was a rogue trader who singlehandedly caused the bankruptcy of Barings Bank due to inadequate operational risk control measures, such as segregation of duties, effective risk reporting and various other reasons (Young, 2006). This incident lead to various institutions to focus on risk management, such as the Basel Committee on Banking Supervision, which subsequently identified principles for the management of operational risk. These principles aim to ensure that one significant risk incident will not cause a major bank to go bankrupt and negatively influence a country's economy.

In addition, Crawford and Hoppe (2005) state that managing operational risk is not new, and for many years organisations in general, and some industries in particular (banking, manufacturing, logistics etc.) have been aware of the hazards and uncertainties arising from IT infrastructure, human resources, fraud, business disruption, legal liability and many similar issues. However, the growing number of business failures, increasing complexity of business and mounting regulatory pressure are renewing visibility of these risks under the banner of operational risk. Other incidents which also attracted the attention of risk experts were the 9/11 World Trade Centre terrorist attack, the London Tube attacks and the tsunami in Thailand. Before the recent increased focus on the management of operational risk it was defined as *all the risk exposures not covered by credit and market risk* (Young, 2006). This definition became unacceptable, especially if one takes into account that, to manage something, one should be able to measure it. Therefore, in 2003 the Basel Committee on Banking Supervision defined operational risk as *the risk of losses due to inadequate or failed internal processes, systems or people, or because of external events*. This definition excludes strategic and reputational risk, but includes legal risk.

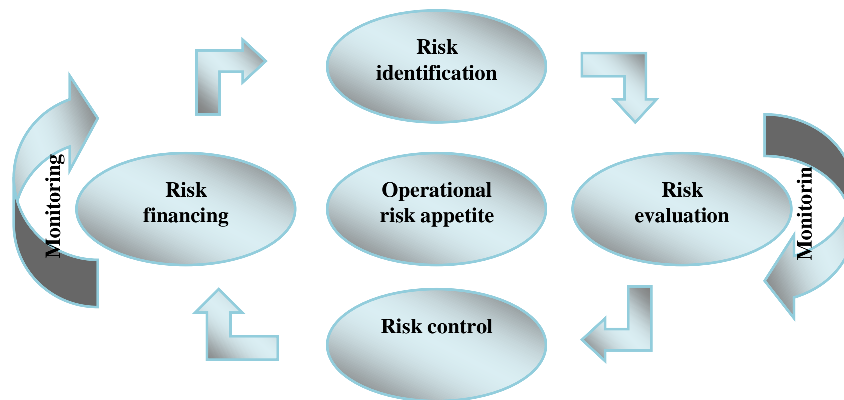
The banking industry was one of the first industries to adopt a more focused approach to operational risk management in consequence of the Basel Committee on Banking Supervision issuing guidelines on how to measure operational risk in terms of expected and unexpected losses. The BSBS suggested that banks should allocate a reserve capital to these unexpected catastrophic risk events in order to ensure that they could survive even in the event of a catastrophic risk incident. However, for this to realise, the banks had to find methods to determine the value of potential losses.

To manage operational risk requires a structured risk management process. A typical risk management process can consist of the following components: risk identification, risk evaluation, risk control, risk monitoring and risk financing. This process is illustrated in Figure 1.

The operational risk management process, outlined in Figure 1, aims to identify and measure the risk exposures associated with operational risk. It is therefore imperative that the operational risk management factors be quantified and/or qualified in order to ensure that the associated risk exposures are managed effectively.

When analysing the descriptions of the risk management factors, it can be concluded that the main theme running through each of these factors relates to losses (loss of staff, funds and/or business). As such, the value of the actual losses is usually based on actual losses linked to financial values. Thus, the only way to quantify operational risk is by means of actual financial losses. A fundamental problem in this regard is the fact that the risk event has already occurred and has resulted in physical financial loss for the organisation, and managing the risk is therefore based on historic financial loss data. To manage future risk exposures, the use of historic loss data is not adequate, as it does not consider the future risk exposures which could have a major influence on the business objectives. However, the risk management process provides the opportunity to determine the overall risk exposures for the organisation.

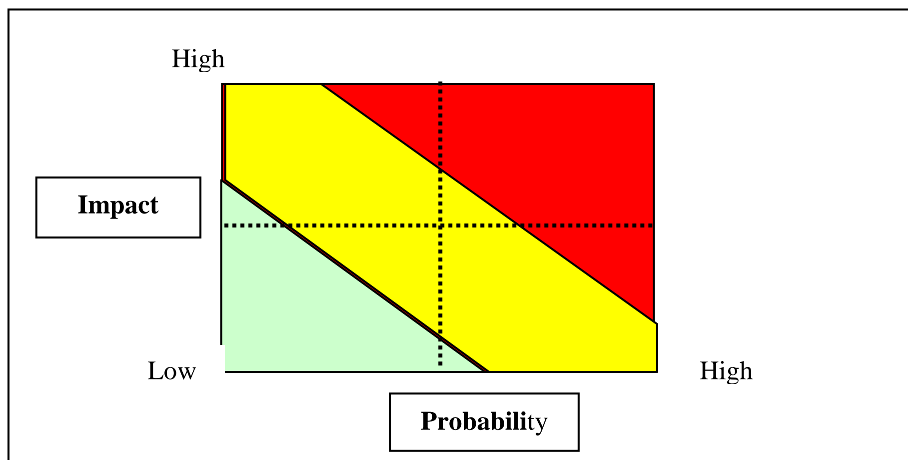
Figure 1. Operational risk management process



Source: Adapted from Young (2006)

After the evaluation process, the residual risk can be mapped to a risk map which could be used to assist management in making decisions. An example of such a risk map is illustrated in Figure 2.

Figure 2. Risk map



Source: Adapted from Young (2006)

When a risk falls in the Low Impact/Low Probability quadrant, it will be tolerated and accepted by management as part of the daily business. In the Low Impact/High Probability quadrant, management will treat these risks by means of additional control measures. In the quadrant with a High Impact/Low Probability, management will decide to share the risk with a third party by transferring a certain amount of the potential risk. This can be achieved by third party insurance. In the last quadrant with a High Impact/High Probability, management would preferably terminate the business or process.

After identifying and evaluating the risks, they must be controlled. Therefore, risk control concerns the application of mitigating techniques to prevent or reduce the probability of losses, and it aims to eliminate or minimise the potential effect of the identified risk exposures.

Risk financing selects the most efficient method for providing (financially) for the neutralisation of risks. Thus, risk financing refers to the provision of sufficient funds to manage the risk and to absorb losses as they occur. This can be accomplished by, for example, a variety of internal and external financial resources, including insurance. It is, however, critical that the cost of risk management does not exceed the benefits of the risk management system.

Risk management is regarded as a dynamic process, because the risk exposures will change as the organisation's business develops. It is therefore imperative that the risk management process must be monitored on a continuous basis to ensure that new risks are identified and proactively addressed. As such, risk monitoring is a continuous management component of the risk management process, and aims to ensure the effectiveness of the risk management system which the organisation is using.

As mentioned above, a challenge for operational risk practitioners is the quantification of the risks. An objective way to quantify operational risk is to use loss history. However, this is not the answer for future potential risks/losses, as it only relates to loss

incidents which have already taken place and does not quantify future risk exposures. As such, various methods have been identified to measure operational risk of which the following are the most popular:

- historical/actual losses;
- key risk indicators (KRIs);
- risk and control self-assessments (RCSAs); and
- scenarios.

Historical loss data provides information on actual risk events which have occurred. The benefit of this information is that value and/or volume can be determined in order to quantify the actual risk. According to the Committee of Sponsoring Organisations (COSO) (2004), quantitative techniques are dependent on the quality of the supporting data and assumptions. These are most relevant for exposures that have a known history and frequency of variability, and which allow reliable forecasting. Benchmarking, for example, is a useful assessment technique which focuses on specific events and compares results using common metrics to identify control measures or improvements. Some companies use benchmarking to assess the impact and likelihood of potential events across an industry. However, this data can only predict future losses and is not accurate.

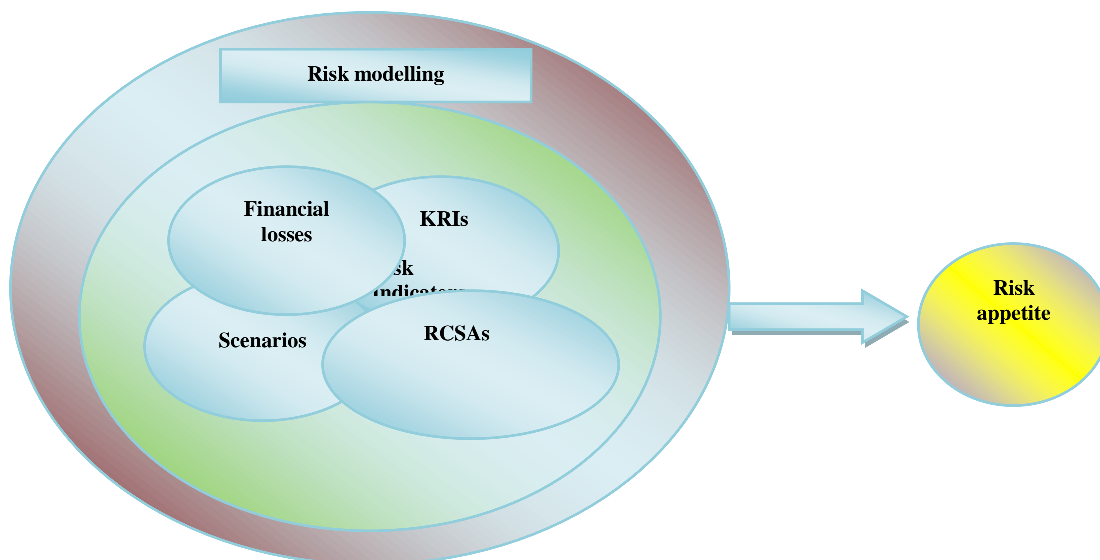
KRIs are risks that have been identified and which are constantly being monitored against benchmarks in order to proactively prevent a risk becoming a major problem to the business. These indicators will alert the organisation to changes that may be indicative of risk concerns. This method of risk management is also a quantitative method and provides information regarding the current status of the identified risk. It can thus serve as an early warning mechanism for management and could ensure that proactive measures are taken to address the risk situation.

RCSAs aim to assess an organisation's risk exposures and activities against existing control measures to determine the residual risk (net risk after taking control measures into account). This method is a qualitative approach which is useful to predict the future risks for the organisation, even though it is also a subjective method.

The scenario approach aims to construct hypothetical events or scenarios which could negatively influence the business. These scenarios are then subjected to a risk analysis to identify the possible risks which must be managed proactively. This method is also aimed at future risks for management purposes.

The primary objective of the above operational risk management tools is to contribute to the determining of the risk appetite. This is illustrated in Figure 3.

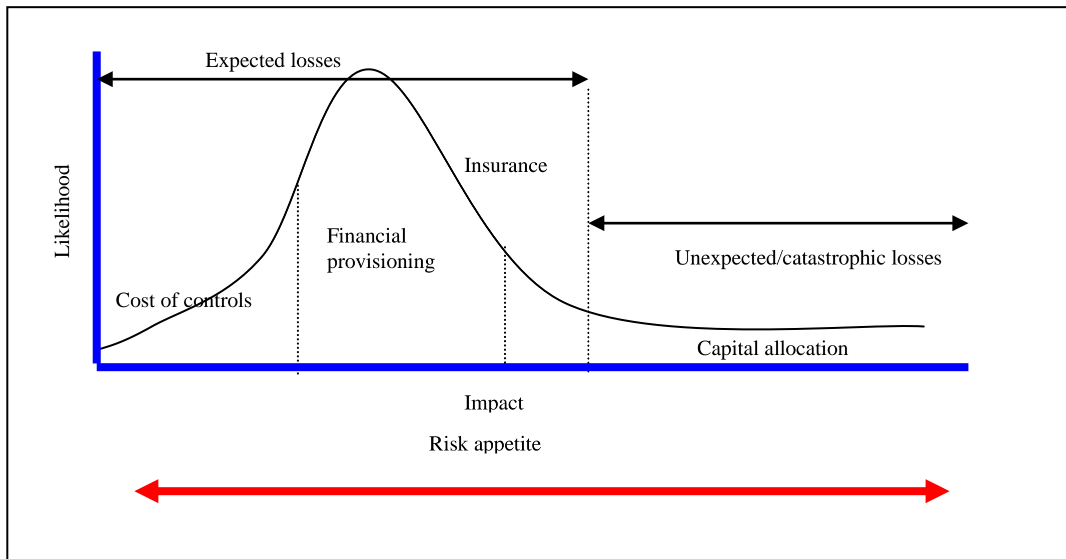
Figure 3. Contribution of risk management tools to risk appetite



(Author's conceptualisation)

Once the qualitative and quantitative data are determined by the risk management tools, risk modelling can be used to calculate the operational value at risk (OpVaR). Risk modelling makes use of stochastic models which focus on an estimation of the risk of specific processes, using, for example, loss data to determine loss distributions that could assist in identifying expected and unexpected losses. A typical example of such a loss distribution curve is illustrated in Figure 4.

Figure 4. Illustration of loss distribution curve



Sources: Adapted from Young (2006) and Institute of Operational Risk (2009)

The loss distribution curve can be used to indicate at which levels of probability and impact the potential losses should be controlled, insured by a third party and capital allocated. This forms the basis for management decisions in terms of reducing or preventing financial losses. Once the loss distribution curve has been divided into the three main categories (control, insurance and capital), it can serve as an input to calculate the operational risk appetite. However, there is still a lot of uncertainty surrounding an exact definition for operational risk appetite which will be addressed in the next section. It is thus firstly necessary to briefly discuss the role and responsibilities of top management (board of directors) as such role and responsibilities relate to the managing of the operational risk appetite.

According to Mongiardino and Geny (2007), in the area of risk governance, a clear description of the role of the board of directors and its committees in setting the risk appetite for the organisation is required. Effective risk management is one of the main responsibilities of the board of directors and they have an important oversight function with regard to risk management.

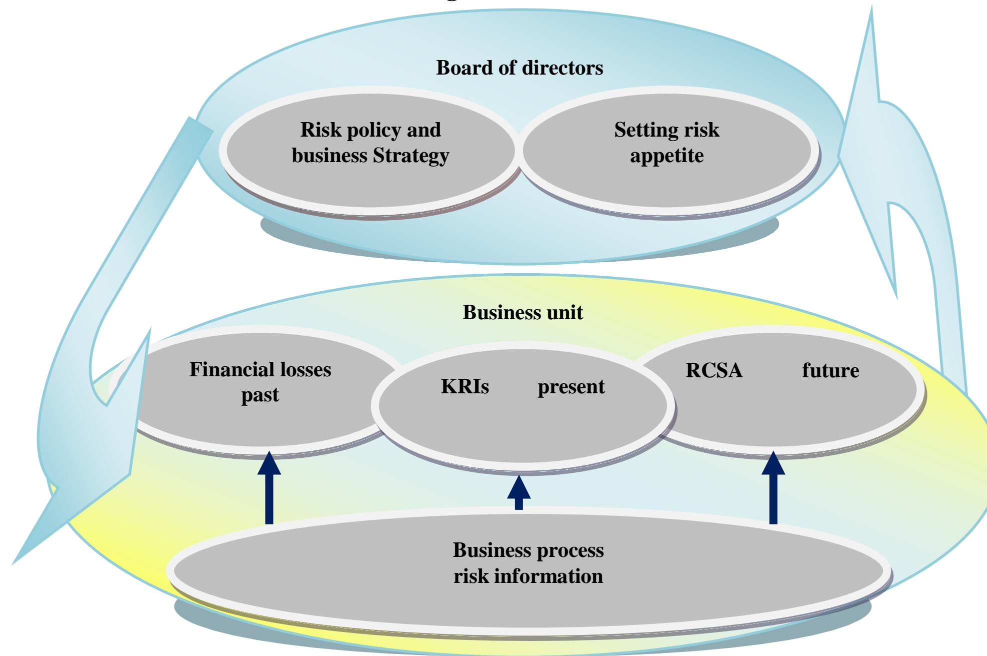
According to COSO (2004), the board should:

- know the extent to which management has established effective risk management in the organisation;
- be aware of the organisation's risk appetite and concur with it;
- review the organisation's portfolio view of risk and consider it against the risk appetite; and
- be apprised of the most significant risks and whether management is responding appropriately.

The board of directors has a major role to fulfil in defining what it expects from senior management at all levels in the organisation regarding risk management. According to Swenson (2003), the board of directors and senior management must be actively involved in the oversight of the operational risk management process. The board also plays a role in setting the organisation's strategy, high-level objectives and the corresponding high-level allocation of resources. These factors can be regarded as the basic requirements to enable management to manage the potential risks involved.

It is clear that the board of directors is ultimately accountable for the effective risk management of the organisation. However, in the context of good corporate governance, it is imperative that, when setting the risk appetite for the organisation, sufficient information be available. Therefore, from a top/down perspective, it is important that the board of directors initiates the risk appetite process by providing the policies and procedures on managing the risks aligned with the strategy of the organisation. From a bottom/up approach the relevant information must be provided to the board in order to set the operational risk appetite. This information evolves from the primary risk management tools. Figure 5 illustrates this concept.

Figure 5. Flow of risk information



(Author's own conceptualisation)

After receiving the risk information, the board must decide on the risk appetite in terms of which financial losses the organisation is prepared to accept as part of the business processes; which losses must form part of financial provisions (budget) which losses must be insured by a third party; and whether any capital must be allocated to potential catastrophic operational risk incidents (refer to Figure 4).

To ensure that the board sets a realistic risk appetite, it is imperative that accurate risk information is generated and reported. Therefore, one of the most important aspects of effective risk management is reporting which is a possible topic for further research. The next section addresses the concept of operational risk appetite in terms of certain concepts which are used to formulate guiding principles for the management of the risk appetite.

3. Operational risk appetite

There are currently a number of definitions for risk appetite which all approach the concept from various angles and sometimes include confusing terms that add to the current misconception of the meaning of the term, not even considering the use thereof. Examples of these definitions are:

- "... the broad-based amount of risk a company or other entity is willing to accept in pursuit of its mission or vision" (Basel Committee on Banking Supervision, 2006)
- "... the probability of financial distress that maximises shareholder wealth" (Nocco & Stultz, 2006)
- "Risk appetite is the degree of risk, on a broad-based level, that a business is willing to accept in pursuit of its objectives. Management considers the business's risk appetite first in evaluating strategic alternatives, then in setting boundaries for downside risk" (Chapman, 2008)
- "... the amount of risk that an organisation is prepared to accept, tolerate, or be exposed to at any point in time" (HM Treasury, 2006)
- "… the amount of risk to which the organisation is prepared to be exposed before it judges that action is necessary" (HM Treasury, 2001)
- "... the level of Enterprise Shock Resistance with which the enterprise risk management committee is comfortable" (Segal, 2006)
- "Risk appetite can be defined as the amount of risk a business is prepared to tolerate at any point in time. A business's tolerance will be a reflection of its capacity to absorb risk" (Chapman, 2008)
- "An organisation's risk appetite is the maximum amount of risk that it can assume. This is an important concept because risk appetite must be set at a level within the capacity limit. Capacity needs to be considered before appetite" (Barfield, 2007)
- "... the willingness of investors to bear risk" (Gai & Vause, 2004)

Although it can be argued that the above definitions of risk appetite are all valid, it is clear that they all differ from one another in one way or another, and that the different definitions relate to different risk types. According to Carey (2005), the high level

of diversity that currently exists regarding the definition of risk appetite is arguably causing confusion within many organisations on how to define, express and use the concept.

Most of these definitions provide a broad view of risk appetite and relate to various risk types, such as operational risk, investment risk and financial risk. Once again, from these various definitions on risk appetite, it is clear that the definitions could cause confusion. As a result of the various risk types involved, it can be concluded that to define risk appetite, it should be done separately for each risk type. A one-fits-all definition could add to the current confusion, and therefore the research on which this article is based, has concentrated on understanding risk appetite as it relates to operational risk. However, the aim of this article is not to present the ultimate definition for operational risk appetite, but to analyse the abovementioned definitions to determine the different terms and concepts used to define risk appetite. These concepts could serve as a foundation to formulate principles for managing risk appetite which, in turn, could be used as a guideline for organisations to determine risk appetite.

An analysis of the abovementioned definitions points towards the key concepts set out in Table 1. These concepts have been used to formulate guiding principles which are also included in Table 1.

Table 1. Key concepts and guiding principles relevant to operational risk appetite

Relevant concepts	Guiding principles
• Acceptance of risk • Amount of risk • Degree of risk	The process to determine the risk appetite should include information regarding the **amount** of financial losses due to operational risk exposures which management is prepared to **accept** as a loss and as part of the operational and business process.
• Capacity to absorb risk • Risk capacity	When considering risk appetite, it should be within the **capacity** limits of the organisation in terms of being able to afford premiums for insurance and to **absorb** financial losses without impairing the sustainability of the organisation.
• Tolerance for risk • Risk exposure at a point in time • Risk assumption	Risk appetite should include the amount of financial losses which an organisation is prepared to **tolerate** as a loss notwithstanding control measures. The **cost** of these control measures must not exceed the potential benefits for the organisation at any **given point in time**.
• Risk-bearing	All **risk-bearing** activities should be considered during the process to determine the risk appetite of the organisation.
• Action required	Risk appetite should indicate sufficient **action required** to effectively manage the risk exposures in terms of the risk map.

These principles could be considered by management when they manage the operational risk appetite. The next section deals with potential benefits when an organisation implements the abovementioned guiding principles for managing operational risk appetite.

4. Benefits of a realistic risk appetite

According to Marsh (2009), risk appetite should be used as a framework to identify when organisations may be accepting more risk than top management have deemed comfortable or alternatively when insufficient risk is being taken to meet stakeholder expectations. A realistic risk appetite set by the board of directors which is based on reliable and accurate risk information will ensure meaningful business decisions. These risk-based decisions should prevent any decisions that will lead to financial losses outside the operational risk appetite. This means that, should a business decision result in a financial loss, it would be covered by the approved operational risk appetite and therefore protects the organisation and ensures its sustainability. Further examples of benefits resulting from a realistic operational risk appetite are:

- Assist strategic planning by aligning strategic objectives and operational activities. This activity will ensure that there are strategic alternatives that could be taken to avoid the risk appetite being breached or to maximise the upside potential (Marsh, 2009).
- Ensure a balanced approach between being risk seeking and risk averse (Institute of Operational Risk, 2009).
- Ensure a better view of risk expenditure which will ensure that the cost of risk does not exceed the benefits (Institute of Operational Risk, 2009). It will therefore ensure that the potential rewards associated with the course of action do not breach the risk appetite levels (Marsh, 2009).
- Enhance a culture of risk awareness throughout the organisation.
- Ensure sound decision-making by top management.
- Enhance corporate governance of the organisation.
- Enhance an improved reputation of the organisation.

- Ensure steps to be taken to reduce or mitigate the risk to bring it within the defined risk appetite (Marsh, 2009).
- Ensure realistic premiums for third party insurance for loss incidents.
- Ensure the involvement of all role players for providing risk information and making sound decisions.

Considering these benefits, it can be concluded that an organisation would definitely benefit from a structured risk management process which will ensure a realistic risk appetite.

5. Research methodology

In order to determine the current knowledge base of employees of organisations as well as the level of implementation and use of the concept of operational risk appetite, it was decided to use the banking industry in South Africa as the target population for a survey. The reason for using banks in South Africa is based on the fact that the banking industry can be regarded as one of the leading industries when it comes to risk management. This fact can be ascribed to the regulatory enforcement by the SA Reserve Bank of the Basel guidelines on risk management to allocate a capital charge to risk exposures. Therefore, it was decided to gather the information by means of a closed questionnaire which was distributed electronically as well as physically to the primary banks in South Africa. The target population was identified across a variety of roles within the bank; for example, members of the board of directors (top management), risk managers, business managers and internal auditors. The main reason for distributing the questionnaire to the aforementioned was that the determining and managing of the risk appetite required the involvement of these role players.

The aim of the questionnaire was, firstly, to determine the current status of implementation of operational risk as a management discipline by the main banks in South Africa. Secondly, the intention was to establish whether the aforementioned guiding principles for managing operational risk appetite could be useful to an organisation when implemented and when ranking these principles in order of priority.

The questionnaire requested respondents to indicate on a 5-point Likert scale their views and experience regarding specific questions on the status of the implementation of operational risk. The response was analysed in terms of descriptive statistics according to the following scale:

1. To a full degree
2. To a degree
3. To a moderate degree
4. To a lesser degree
5. To no degree

Respondents were also requested to rank, in order of importance, the identified guiding principles for managing operational risk appetite as well as the potential benefits.

6. Research results

The questionnaires were randomly distributed to employees of the four major banks in South Africa. A total of 50 questionnaires were dispatched, and 33 were returned on the due date which represents a 66% response.

Feedback was received from one top manager, 3 internal auditors, 17 business managers and 12 risk managers.

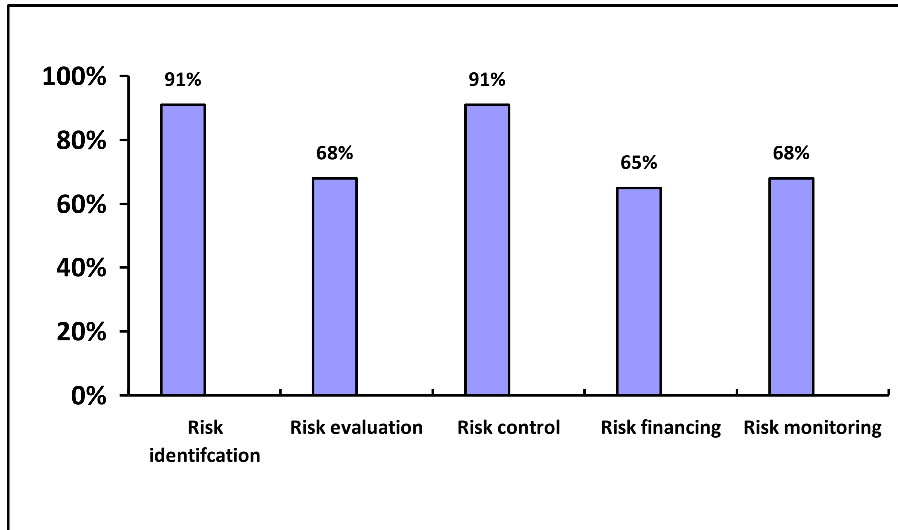
The respondents mostly consisted of risk managers and business managers who represent the important role players involved with managing a bank's risks. Therefore, the response can be accepted as a reasonable reflection of the status of risk management in the banking industry in South Africa.

Regarding the current understanding and implementation of operational risk, 85% of the respondents have indicated that operational risk management is being managed to a full degree as a separate risk management discipline, and that a specific definition for operational risk has been accepted by the organisation. Of the respondents, 77% have indicated that a policy on operational risk has been approved to a full degree by top management, while 70% have indicated that the policy has been distributed to a full degree throughout the organisation.

Based on this response, it can be concluded that operational risk has been recognised as an independent risk management discipline, although there may be a need to inform all employees on the approved policy and to actively distribute it throughout the organisation.

Regarding the status of the implementation of an operational risk management process, the respondents have indicated that the components of a typical process are being implemented. Refer to Figure 6 below.

Figure 6. Status of the implementation of the operational risk management components

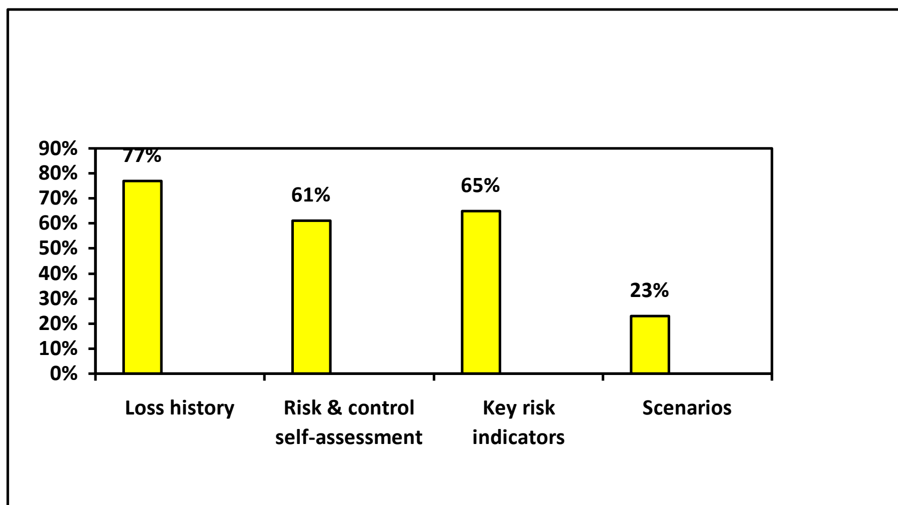


It can be concluded that risk identification and risk control are the two components currently receiving most attention (91% of the respondents have indicated that these components are being implemented to a full degree) as part of the risk management process. Risk financing is the component which is being implemented to a lesser degree (65% of the components have indicated that this component is being implemented to a full degree, while 26% have indicated that it is used to a moderate or lesser degree). As the operational risk appetite forms an integral part of the risk financing component of the risk management process, it can be concluded that the application of the risk appetite process still requires some attention to ensure the realisation of the benefits of such a process.

In terms of the implementation and use of the operational risk management tools, 91% of the respondents have indicated that risk and control self-assessments are being implemented to a full degree with 100% indicating that loss history is being used, while 83% and 29% have indicated that key risk indicators and scenarios are being used to a full degree respectively. It can, therefore, be concluded that the losses management and risk, and control self-assessments are the two most popular risk management tools, while the use of scenarios to manage risks is still being developed.

When comparing the use of the risk management tools as an input to determine the operational risk appetite, it can be deduced that this is still in the development phase (refer to Figure 7) with the loss history as the most popular risk management tool, followed by risk and control self-assessments.

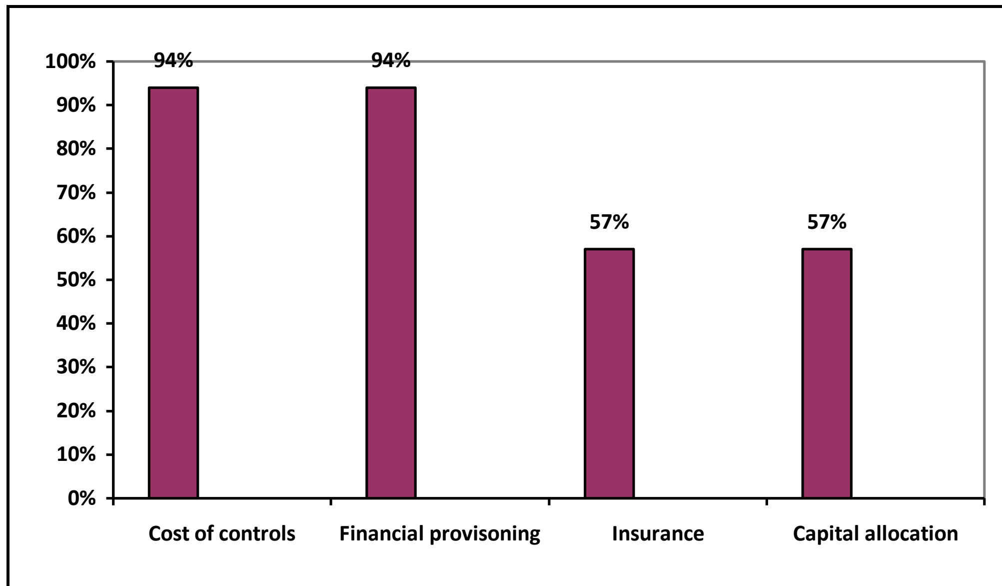
Figure 7. Status of the implementation of the operational risk management tools as an input to determine the operational risk appetite



Of the respondents, 11 have indicated that risk modelling is used to a degree, while 14 have indicated that it is not used. As such, it can be deduced that banks are mostly still in a development phase regarding risk modelling for operational risk. Similarly, it can be concluded that the use of a loss distribution curve is also still being considered or developed to determine the risk appetite.

The implementation of the various components which can be used to quantify the operational risk appetite is illustrated in Figure 8.

Figure 8. Components to quantify operational risk appetite



Of the respondents, 94% have indicated that the cost of controls and the financial provisioning are being used to a full degree as part of the operational risk appetite, while 57% have indicated that insurance and capital allocations are being used to a full degree. As such, it can be concluded that the components to quantify the operational risk appetite can be regarded as the cost of controls, finance provisioning, insurance and capital allocation.

The respondents indicated prioritising the guiding principles for managing operational risk appetite in order from most important to least important (Refer to Table 2).

Table 2. Priority rating of the guiding principles to manage operational risk appetite

Principle	Percentage	Rating
All risk-bearing activities should be considered during the process to determine the risk appetite of the organisation.	40.9%	1
The risk appetite should include the amount of financial losses which an organisation is prepared to tolerate as a loss, notwithstanding control measures. The cost of these control measures must not exceed the potential benefits for the organisation at any given time.	34.8%	2
When considering the risk appetite it should be within the capacity limits of the organisation in terms of being able to afford premiums for insurance and to absorb financial losses without impairing the sustainability of the organisation.	31.8%	3
The process to determine the risk appetite should include information regarding the amount of financial losses due to operational risk exposures which management is prepared to accept as a loss, and as part of the operational and business process.	16.7%	4
The risk appetite should indicate sufficient action required to effectively manage the risk exposures in terms of the risk map.	12.1%	5

The most important guiding principle for managing operational risk appetite was rated as the first priority (40.9%), while the lowest priority was rated 12.1%. There is no principle that has not been rated which can lead to a conclusion that all the

principles can be accepted as guiding principles for managing operational risk appetite.

Table 3 shows the rating of the potential benefits for implementing the guiding principles when managing the operational risk appetite. Similar to the rating of the principles, all the benefits have been rated with the highest rating at 37.8% and the lowest at 3.0%.

Table 3. Priority rating of the potential benefits as guiding principles for managing the operational risk appetite

Principle	Percentage	Rating
Assist strategic planning by aligning strategic objectives and operational activities.	37.8%	1
Ensure a balanced approach between being risk seeking and risk averse.	31.8%	2
Ensure a better view of risk expenditure which will ensure that the cost of risk does not exceed the benefits.	28.7%	3
Ensure sound decision-making by top management.	22.7%	4
Enhance corporate governance of the organisation.	16.7%	5
Ensure the involvement of all role players by providing risk information and making sound decisions.	15.2%	6
Ensure realistic premiums for third party insurance for loss incidents.	13.6%	7
Enhance an improved reputation of the organisation.	4.5%	8
Enhance a culture of risk awareness throughout the organisation.	3.0%	9

It can, therefore be concluded that the proposed guidelines would assist organisations during the management of the operational risk appetite.

According to the response it is clear that the identified advantages for implementing the guiding principles for the management of operational risk appetite would be to the benefit of the organisation.

7. Conclusions

This study provided some insights into the implementation of operational risk management. It is evident that operational risk management is fast becoming a management discipline in its own right. However, to be able to manage it effectively, it is imperative to demarcate the factors of operational risk, and to quantify and qualify these by means of an embedded operational risk management process. This process must provide sufficient risk management information to top management in terms of the past financial losses, and current and future risks. This risk information, generated by the risk management tools, forms the basis for the board of directors to set a realistic operational risk appetite which, in turn, will ensure sound financial decisions in terms of the cost of risk, financial provisions, third party insurance and capital allocation.

The study analysed various definitions of risk appetite from which were identified specific terms that could assist in formulating guiding principles for managing operational risk appetite.

Several benefits of implementing the guiding principles to manage operational risk appetite were also proposed.

Five guiding principles for managing operational risk appetite were identified with nine potential benefits, should the principles be implemented. The principles as well as the benefits were put to a sample of 50 respondents from the banking industry. The respondents were required to rate the extent to which each of the principles and benefits applied to their understanding.

The conclusion that can be drawn from the findings is that the principles and benefits were all found to be applicable. The principle which has been rated most important is that all risk-bearing activities should be considered during the process to determine the risk appetite of the organisation. The benefit rated with the highest ranking envisages that the management of the operational risk appetite can assist in strategic planning by aligning strategic objectives and operational activities.

Although the findings of the study are related to only the banking industry, it is quite possible that the results might be the same for any other organisations because of the generic nature of the identified guiding principles. This possibility could be tested in subsequent research.

It is finally recommended that organisations, particularly banking organisations, seriously consider the adoption of the guiding principles for managing their operational risk appetite which could lead to the stated benefits from improved corporate governance to sound decision-making.

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INCREASING SUSTAINABLE ORGANISATIONAL DEVELOPMENT BY USING E-PORTFOLIOS

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Abstract

Feedback from business students using e-portfolios indicated it stimulated reflection, guided career management and improved technological skills. At first glance, these key benefits seem only applicable to individuals. However, at a closer look it is clear that these key benefits are also applicable to teams and organisations. Reflection is crucial in fast changing environments demanding action, multitasking through many technologies and competing in an increasingly interconnected world. Career management is a known factor to retain employees leading to sustainable organisational development and ongoing competitive advantage. Improved technological skills apply to all sectors in an organisation. Based on this reasoning, an e-portfolio is proposed as one tool beneficial to the business environment and this article provides practical guidelines for implementation.

Keywords: organisations, technological sector, e-portfolios

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1. Introduction

The value added contribution of this article is threefold. Firstly, it potentially raises awareness among board members, business managers and employees regarding using the e-portfolio as more than a repository to demonstrate accomplishments but as a tool to increase reflection, assist to assess current goals and plan future goals, guide and support personal and professional development, and improve technological skills. Secondly, it argues that reflection has definite benefits to the individual and the organisation and that employees value career development and professional development opportunities as a means of retention. Thirdly, it provides a practical contribution through guidelines to members of boards, managers and employees for implementing e-portfolios. These practical guidelines are based on recommendations by business students who have used the e-portfolio, the lessons learned by this author, and supported by literature.

Based on the feedback from a group of Masters level business students who used an e-portfolio (where the author was the academic) it was clear that the e-portfolio is more than a repository tool for information. What stood out was that the e-portfolio has three interlinked and interrelated key benefits, namely it:

- stimulated reflection (self-reflection and critical thinking);
- guided career management; assisted to assess current goals and plan future goals;
- improved technological skills.

These findings were consistent with literature (Magill & Herden, 1998; Dubinsky, 2003; Trounson, 2008; Kimball, 2002; Hardin & Cook, 2001; Leece, 2005; Fennel, 1998). The author of this article opinionates that the insight gained from this group of business students is transferable to a business context and valuable to board members, business managers and employees. In addition, the students stated clearly that the e-portfolio is a valuable tool for the workplace. At a first glance, it seemed that all these key benefits are only applicable to individuals. However, at a closer look it was clear that these key benefits were also applicable to teams and organisations.

Reflection (stated as the first key benefit of the e-portfolio) is crucial in fast changing environments demanding action, multitasking through many technologies and competing in an increasingly interconnected world (Hedberg, 2009; Cambridge, 2008) where practitioners need to quickly learn new skills, make independent decisions and find creative solutions (Barlett & Ghoshal, 2002; Khandekar & Sharma, 2005). Reflection assists practitioners to take more thoughtful, purposeful, meaningful and value-driven action (Hedberg, 2009; Raelin, 2001). However, critical reflection does not come naturally to many and has to be facilitated by training through reflective processes and tools (Gray, 2007).

Career management (stated as the second key benefit of the e-portfolio), including assessment of current goals and plan future goals, are highlighted by numerous authors and in research projects (Holtom *et al.,* 2006; Klein, 2009; Pillay, 2009; Meyer *et al.,* 2004; Cascio, 2006; Messmer, 2006; Morris, 2007; Kock & Burke, 2008; Naudé, 2009; Reiss & Costello, 2007; Tyler, 2007) as retention factors for employees. Retaining employees is one strategy facilitating sustainable organisational development crucial for strategic and competitive advantage and to survive over the short and long-term (Clulow *et al.,* 2003).

It is a universal assumption that improved technological skills (stated as the third key benefit of the e-portfolio), apply to all sectors in an organisation and have definite benefits in an increasingly interconnected and technologically driven business environment.

This article is presented in three parts. The first part will briefly discuss the main reasons for selecting an e-portfolio, the context for implementation, what the e-portfolio looked like, and feedback from a group of Masters level business students which formed the basis for this article. Part two will discuss relevant literature which the author used as a basis for the arguments. This section explores the literature related to particular aspects of e-portfolios, reflection in business and career management. The last part will discuss practical guidelines for members of boards, managers, employees regarding the effective implementation of e-portfolios.

2. Use of an e-portfolio for business students

Within the scope of this article, the author does not aim to provide a detailed discussion of the implementation and outcomes from an e-portfolio for Masters level business students. However, a snapshot and brief discussion provides background information to the reader.

2.1 Reasons for selecting the e-portfolio

Based on evidence from the literature (which is discussed in more detail later), it seemed to the author that the e-portfolio was at the time an applicable tool to capture evidence of accomplishments (such as learning objectives), encourage reflective learning and thinking, stimulate personal leadership development and long-term professional development.

The author accepted two valuable principles stated by Chappell and Schermerhorn (1999). Firstly, once it is decided to implement the e-portfolio it should be mandatory to overcome the resistance or avoidance by students who are technologically adverse. Secondly, students are encouraged to recognise and acknowledge their technological and computer shortcomings and they should be given support to overcome those problems. To overcome resistance and technological difficulties training sessions were organised.

2.2 Context for implementation

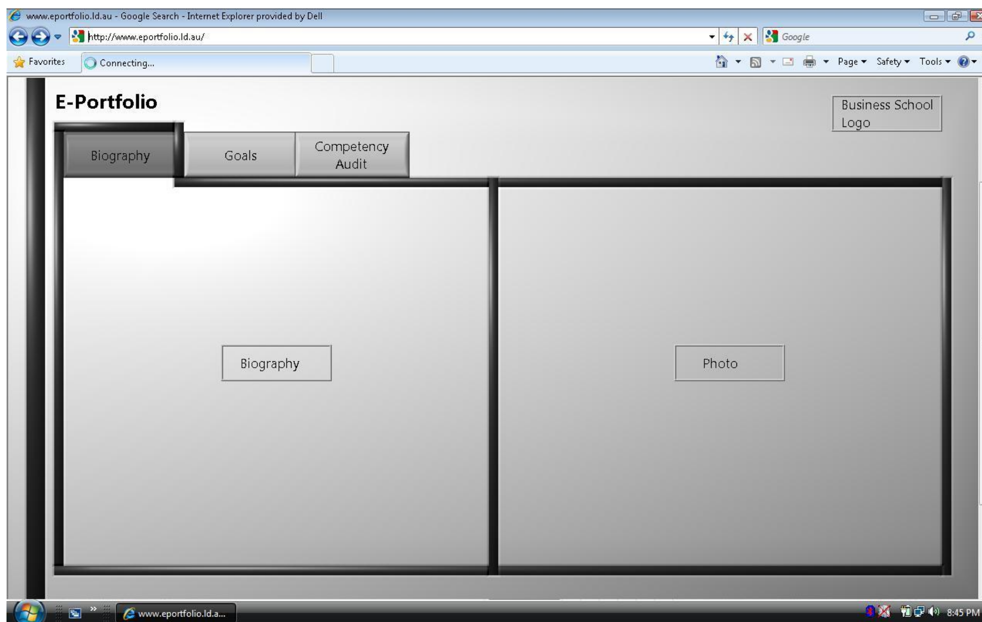
The author was the academic teaching a Leadership Development unit (subject) in a Business School and the students enrolled in this unit are studying towards a Masters level Business degree. Seventy-two students used the e-portfolio. The average age was 35 (ranging from 30-55) and 85% were undertaking part-time studies while working full time. Within this group, all students have completed a Bachelor degree and a minimum of 5 years work experience as a manager.

2.3 What the e-portfolio looked liked

The e-portfolio was introduced to capture the attainment of the learning objectives for the unit. However, to ensure a holistic picture, the author asked the students to include a brief Resume/CV, and both personal and professional goals for the following 3 years. Although commercial e-portfolios are available, the author used an e-portfolio that was designed in house and based on Internet accessed forums, for example Facebook or LinkedIn. A screen view similar to the implemented e-portfolio is shown in Figure 1.

At commencement of the unit (and before students started the e-portfolio), the author and an IT support staff member presented a 2-hour training session (supported by comprehensive handouts) to ensure students understand the aim of the e-portfolio both in general and in the unit, and understand how to use the technology. Thereafter, the students used the e-portfolio for a period of 14 weeks (one trimester) which is the duration for the unit.

Figure 1. Example of a possible format



2.4 Feedback from the students

As the author was interested in the students' experience of the e-portfolio, they were asked to provide feedback at the end of the trimester. Although providing feedback was voluntary, all the students contributed anonymous written feedback. For the purpose of this article, the three key benefits are discussed, supported by verbatim statements to reflect the 'voice' of the students.

Stimulated reflection

The majority of students clearly indicated that the e-portfolio stimulated reflection on strengths and weaknesses, ideas, problems, alternatives, personal and professional areas to develop. They highlighted the value of reflective thinking in the classroom but also within the work place (as an individual and in a team) by stating:

"*It was an opportunity to reflect on my capabilities and where I need to improve. It also helps me to reflect on alternatives and solutions to different problems*"
"*It helped me understand the importance of reflective thinking, both professionally at work and at university to critically analyse the knowledge and practices on a personal level and when working in a team* "
"*The e-portfolio allowed me to assess what I had achieved, reflect on this and formulate an action plan to improve my capabilities*"

Assisted to assess current goals and plan future goals; guided career management, personal and professional development

Students stated that the e-portfolio assisted in assessing their current goals, and plan goals for the future (to 'look back' and 'look forward). In addition, comments that the e-portfolio process encouraged direction were common. Statements included:

"*Writing down the Professional and Personal Goals made me re-think my goals and objectives*"
"It provided me with a wonderful opportunity to look back and assess my skills and then to look forward to set goals, direction and aspirations for myself"

In addition to assessing current goals and plan future goals, it was evident that the e-portfolio can be used as a tool for career management and to guide and support personal and professional development through increased reflection on strengths and limitations and motivation to learn more or develop particular capabilities. Comments highlighted the use of the e-portfolio for performance management. In addition, students indicated the use of the e-portfolio outside education and within a work place setting.

"*The e-portfolio helped me devise strategies and action plans to better my skills and abilities over the next couple of years*"
"*Good for future use such as career planning or career management to guide and support my professional development*"
"*Provided a valuable tool to use for personal performance management, goal setting and ongoing professional development*"

Improved technological skills

It was evident that the e-portfolio improved technological skills and this is applicable to every sphere in business. It was evident at the training sessions that many students possessed only basic computer skills and students mentioned that they gained both particular and general technological skills. Some students mentioned they will value and use these skills in the future, for example:

"*I developed specific skills such as patience and to 'save' very often as well as more specialised skills such as to attach a video*"
"I d*eveloped my understanding of PowerPoint and the different functions for better presentation of any assignments or portfolios in future in my course and in the work place*"

3. Theoretical framework

Applicable literature from several theoretical frameworks is used as a basis for argument in this article. The author believes that all the benefits of the e-portfolio to both the individual and organisation are interlinked and interrelated. However, for practical and structural reasons, these aspects are presented as separate entities.

E-portfolio as more than a repository tool

It is well documented that the e-portfolio has many benefits. A brief snapshot of the general benefits of the e-portfolio is included in this discussion to provide and overall picture and for the benefit of the novice e-portfolio user. However, the main focus is on the key benefits applicable to this article, namely that the e-portfolio:

- stimulated reflection (self-reflection and critical thinking);
- guided career management; assisted to assess current goals and plan future goals.

It is a universal assumption that improved technological skills (stated as the third key benefit of the e-portfolio), apply to all sectors in an organisation and have definite benefits for both the individual and the organisation in an increasingly interconnected and technologically driven business environment. Therefore, this aspect is not further explored in the literature.

Firstly, the overall benefits of the e-portfolio are well researched and recorded. Although the paper-based portfolio is well known, the e-portfolio has the benefits (Barrett, 2000; Corbett-Perez & Dorman, 1999; Piper 1999; Trounson, 2008) that it:

- is easy to create, keep-up-to-date, manage and store information and artifacts;
- looks professional, is easily portable and transferable;
- can be modified to reflect different levels and ranges of competencies and accomplishments;
- can be personalised with individual touches such as sound and multimedia;
- is able to capture and integrate previous experience and learning;
- combines narrative, digital and multimedia work to present a holistic picture of the person's work.

Secondly, the e-portfolio stimulated reflection (self-reflection and critical thinking) as it encourages the individual to reflect on competencies and capabilities (Trounson, 2008; Hackney, 1999), strengths and weaknesses (McCowan *et al* 2005; Kimball, 2002; Hardin & Cook, 2001). The e-portfolio development process is dynamic, complex, thought provoking and it includes self-reflection, problem solving and decision making (Salend, 2001; Kimbal, 2002). In effect, this process (or series of processes) moves thinking from a linear to an integrated approach (Fitch *et al.,* 2008). In addition, when deciding on the content to include, the individual needs to reflect on and understand the connection between different e-portfolio components which enables employees to become architects of life-long learning (Dubinsky, 2003; Fitch *et al.,* 2008; Zhang *et al.,* 2007; Barrett, 2000). As a product, the e-portfolio demonstrates the variety, depth and range of the individual's achievements, knowledge gained from continuous learning processes, outcomes of constant resource collection, self-reflection and re-design (Denzine, 2001; Fennel, 1998; Corbett-Perez & Dorman, 1999; Magill & Herden, 1998; Zhang *et al.,* 2007). In the work place e-portfolios encourage teamwork, creative thinking, analysis, comparison, decision-making, problem solving (Corbett-Perez & Dorman, 1999) and promote interaction and collaboration among the employees (Zhang *et al.,* 2007).

Thirdly, the e-portfolio guided career management and assisted to assess current goals and plan future goals (McCowan *et al.,* 2005; Kimball, 2002; Hardin & Cook, 2001; Hackney, 1999). The process to develop an e-portfolio increases awareness related to the individual's own learning processes and activities to accomplish personal and professional growth (Fitch *et al.,* 2008). As the e-portfolio demonstrates a unique collection of individual goals, evidence of depths of accomplishments, it is appropriate for job applications (Williams, 2008; Nikirk, 2008; Salend, 2001; Kimbal, 2002), application for promotions and personal marketing (Chappell & Schermerhorn, 1999; Denzine, 2001; Nikirk, 2008; Leece, 2005). E-portfolios encourage employees to take advantage of opportunities, bring a greater clarity of purpose, a higher level of motivation and encourage personal and professional growth (Fennel, 1998; Denzine, 2001). In the workplace, the e-portfolio guides and supports long-term personal and professional development, could be used in combination with other performance management processes and tools (Denzine, 2001) and may be linked to standards for professional licensing (Barrett, 2000). E-portfolios are attractive to professions such as health, teaching and engineering (Trounson, 2008). Anderson *et al.,* (2001) opinionates that e-portfolio-based learning requires a high form of skill and knowledge integration as individuals need to reflect on the development of their professional skills in the process of creating their professional identity.

Reflection in business environments

Reflection is a multifaceted concept and there are numerous benefits for the business environment. At least two of these benefits applicable to this article are highlighted.

Firstly, reflection is a very important skill to practitioners (managers and employees) in fast changing business environments demanding action, multitasking through many technologies, and competing in an increasingly interconnected world. Practitioners need to quickly learn new skills, make independent decisions and find creative solutions (Barlett & Ghoshal, 2002; Khandekar & Sharma, 2005; Brooks, 2005; Pemberton *et al.,* 2001). It is through reflection that practical experiences become meaningful and practitioners use active and purposeful discovery, are enabled to analyse a situation, collect relevant facts, sort through alternatives, develop creative solutions, ponder recent events and the immediate environment (Hedberg, 2009; Gray, 2007; Raelin, 2001). However, reflection is not a substitute for action or a strategy for procrastination. Practitioners who build reflective thinking into their decision making processes take more thoughtful, purposeful, meaningful and value-driven action (Hedberg, 2009). Gray (2007), Pavlovich *et al.,* (2009), Salend (2001) and Vince (2002) contended that reflection allows practitioners to challenge assumptions, develop more collaborative, ethical and responsible ways to manage organisations, become receptive of alternate ways of behaving and reasoning, develop new understandings, continuously examine impact of decisions and actions, apply new learning and perspectives to future endeavours.

Secondly, another line of reasoning emphasises effective management and sharing of knowledge combined with organisational learning enhances both competitive advantage and business performance. Consequently, organisations need to develop a culture of learning and reflection (Pemberton *et al.,* 2001). Cambridge (2008) was of the opinion that problems increasingly defy specialised solutions, knowledge and culture is constantly remixed, boundaries between personal and professional are unclear, patterns of employment necessitate flexibility and independence. Although practitioners are operating in a very fast-paced environment, action without reflection could be fatal to the success of an organisation (Raelin, 2001). Skilled and motivated employees are central to create and maintain competitive advantage and sustainable organisational development (Barlett & Ghoshal, 2002; Khandekar & Sharma, 2005). In addition, there is a continuous focus on aligning informal and formal learning, using innovative learning tools and technologies to assist individuals, enhance productivity and innovation, drive and contribute to business results (Hall, 2009; Svenson & Ellstrom, 2004; Walters, 2009). In addition, reflective employees reinvest in learning by seeking more challenges, participating in ongoing education, engage in problem solving, continually build on their solution database rather than selecting the first workable solution, view inconsistencies as opportunities and enjoy reflecting on their decision making and actions (Raelin, 2001).

Career management as retention factor for sustainable organisational development

There are many individual and organisational benefits ascribed to effective career management. However, for the purpose of this article, the focus is twofold. Firstly, the benefits to and expectations of the individual are highlighted. Secondly, the importance of employee retention (which is a benefit of career management) in the sustainable development of organisations is briefly discussed.

Firstly, it is well documented in various research and literature (Curtis & Wright, 2001; Casey & Warlin, 2001; Friedrich, 2001; Holtom *et al.,* 2006; Klein, 2009; Pieper, 2003; Pillay, 2009; Meyer *et al.,* 2004) that ongoing career management and professional development is important. Ongoing professional development starts with induction, orientation and socialisation of newcomers. Multiple authors (van Leeuwen *et al.,* 2005; Kock & Burke, 2008; Holtom *et al.,* 2006; Numerof *et al.,* 2004; Pilay, 2009; Karson, 2007) found that employees not only value ongoing personal and professional development but also want and expect new and challenging opportunities and work (Coile, 2001; Frauenheim, 2006; van Leeuwen *et al.,* 2005). In addition, Morris (2007) stated it was evident (among Canadian employees) they were looking for training and ongoing learning combined with active career advancement.

Secondly, employee retention is crucial for sustainable organisational development, development and maintenance of a strategic and competitive advantage (Franklin, 2006; Hatch & Dyer, 2004; Khandekar & Sharma, 2005; Sun & Tse 2009). A 2005 Gantz Wiley Research report stated the opportunity for career development is one of the top 5 drivers for employee retention (Cascio, 2006). Messmer (2006) supported this opinion and added that one of the key reasons why employees leave organisations is because of a perceived lack of career development. It is well-known that long-term employees have a strong knowledge base, pass their knowledge, skills and experience to new employees and build the morale in the organisation (Barlett & Ghoshal, 2002). Conversely, the organisation looses the knowledge, skills and experience when employees leave. As a result, retaining employees is crucial to keep the knowledge and experience within the organisation contributing to profit, sustainable organisational development, strategic and competitive advantage (Franklin, 2006; Hatch & Dyer, 2004; Khandekar & Sharma, 2005; Sun & Tse 2009). Khandekar and Sharma (2005) and many others

(Boxall, 1996; Boxall & Steeneveld, 1999; DeSaa-Perez & Garcia-Falcon, 2002) all view employees as a valuable resource. Employees possess scarce codified and tacit knowledge and expertise which cannot (like capital) be accumulated at the top of the organisation and then distributed where and when needed employees are embedded at every level influencing all processes and relationships (Barlett & Ghoshal, 2002; Contino, 2002).

4. Practical guidelines

This last part of the article provides practical guidelines to members of boards, managers and employees for implementing e-portfolios. These practical guidelines are based on recommendations by the business students involved in the e-portfolio, the lessons learned and insights gained by this author, and supported by literature.

4.1 Voluntary or compulsory

Chappell and Schermerhorn (1999) were of the opinion that once there was a final decision to implement the e-portfolio in the organisation, it should be compulsory for employees to overcome resistance or avoidance.

4.2 Format

Technological difficulties must be minimised to allow the employees to focus on the content and process of the e-portfolio and not get distracted and/or discouraged by technological difficulties. Therefore, a very user friendly format is crucial. Internet accessed forums, for example Facebook (for social networking) or LinkedIn (for professional networking) are well known and most employees are familiar with these. Following this logic, a basic Internet based website that contains the e-portfolio has a 'familiar feel', is easy to access and use. It is advisable that organisations firstly, analyse the employees' needs and the purpose for the e-portfolio. Then secondly, evaluate the commercially available e-portfolios from various software companies for suitability. Lastly, make the decision between a commercially available and an in-house developed e-portfolio. An extremely important factor is that the chosen the e-portfolio format should allow private ownership to the employee. In addition, it must be password protected to ensure privacy and confidentiality of information. Similar to Facebook and LinkedIn, the owner should be able to invite others to view the content and/or to participate. The author suggests an easy to use format that is both basic enough for beginners and allows flexibility to employees who want to use advanced functions (such as video clips). This was also the opinion of Dubinski (2003), Jafari (2004) and Carney (n.d).

4.2 Training

Chappell and Schermerhorn (1999) suggested that employees are encouraged to acknowledge their technological and computer limitations and be given support to overcome those. Following this logic, training and information (clarified by multiple examples) before and during the implementation of the e-portfolio are advisable.

Timing

The timing of the training is very important and initial and follow-up sessions are advisable. The initial training should be scheduled before the employee is expected to commence with the e-portfolio. Thereafter, follow-up (refresher) sessions are offered according to identified needs within the particular organisation. Student feedback supports this approach:

"*I could not have done this without the training right at the start*"
I appreciated the training at the start of trimester as it allowed me to start and the 'refresher' half way was very helpful"

From the author's experience, the initial sessions should be a maximum of 2 hours as a longer session could be overwhelming. All sessions should include a general (information and demonstration) component as well as a 'hands on' (practice) component. In addition, there should be ample time allowed to address questions from the employees.

What to include

The initial session needs to include both the overall use of the e-portfolio and the specific use within the organisation. In addition, technological skills training should prepare and guide employees to access the e-portfolio, manage documents, insert evidence or artefacts, and invite other employees and/or viewers into their e-portfolio. Technological skills training should focus on the needs of both the novice and advanced user. The novice user needs the basic skills to get started, fulfil the minimum expectations and overcome the initial resistance and fear. The advanced user needs more advanced and creative skills to include special effects (such as photos, short videos, animated PowerPoint slides). It must be made clear that employees need to select the most applicable evidence and artefacts to demonstrate a skill or knowledge. Many employees need technological information and a practical demonstration on particular aspects, such as how to condense the size of files as 'space' is always limited.

Based on the students' feedback, the examples (including examples of good and bad e-portfolios) that were shown during the training made it real (especially for the novice user). Although the author included numerous examples in the training sessions, there was a clear demand for even more. Student comments included:

"I had no idea what an e-portfolio looked like and the examples brought it to life and made it a bit more real"

"Liked the real life examples. They gave me some ideas for my own e-portfolio"
"*To have even more examples of e-portfolios would give a better understanding of what an e-portfolio is and what one actually looks like*"
"*Maybe shown us more examples of good and bad e-portfolios*"

For confidentiality and privacy reasons, it is crucial that owners of examples are contacted for written permission to use their examples on the organisational website (if that is planned) or during the training sessions prior to these aspects being used. Usually the owner is not named but only the example provided.

4.3 Ongoing support

Based on the author's experience and supported by the feedback from the students, hard copy hand outs are recommended to provide a future reference and a support system. Students stated:

"The hard copy handouts were great as I could refer back to the notes when I got stuck"
"I need hard copy notes when I struggle with technology and do not want to struggle with more technology such as a website to sort out my technology problems!"

If possible, information and examples could be placed on the organisation's website to allow employees to revisit these.

Dubinski (2003), Jafari (2004) and Carney (n.d) opinionated that employees might experience 'cognitive overload' when they are trying to become adept with technology while simultaneously reflecting on learning. Following this logic, it seems that employees who are working at the limits of their technological and computer skills have very little cognitive time and energy left for thinking, reflection and achieving goals. Conversely, when there is no real need to worry about their technological and computer skills, employees can concentrate on the e-portfolio process and content. Similar to these opinions, the author learned that ongoing support from a real person was crucial to alleviate the initial fear, frustration, difficulties or to share the success and the joys. A support person could be a dedicated technological person or an employee who is confident in working with the e-portfolio. Support should be available by telephone, email and/or individual 'hands on' sessions and is invaluable to ensure employees become comfortable with the technology and resolve problems as soon as possible. A voluntary 'buddy' system could be effective where employees who feel they are more advanced users and are willing to 'buddy' with more novice users to provide information, technological assistance and overall support. Support (in whichever format) is very important to allow employees to focus on the reflective aspects and insights from the e-portfolio process and not be bogged down or be frustrated by solvable technological difficulties. The author does not recommend support on full time 24 hour basis as it is impractical and not sustainable. However, employees should be able to obtain information and assistance easily and the response time should be short (and definitely within 24-48 hours).

4.4 Collaborative process

In addition to the previously discussed guidelines, Denzine (2001) suggested:

- Use a collaborative and participative process (involving interested employees) to develop and implement the e-portfolio as opposed to it emanating from management.
- Emphasise and be very clear that the e-portfolio is a collaborative opposed to a competitive tool. There should be no competition regarding who has the most information or artefacts or the most complicated special effects in the e-portfolio. Using the e-portfolio should focus on a selective process of analysis, critical thinking, decision-making and problem solving through collaborative support from managers and colleagues. Employees are encouraged to invite managers and colleagues to provide feedback and insights on each other's e-portfolios. In addition, managers could provide artefacts (such as a congratulatory letter) for employees' e-portfolios.
- Competent employees (at different levels in the organisation) could act as advisors to employees who are new to the e-portfolio process and/or the organisation.

5. Conclusion

Based on the lessons learned, insights and understandings gained by the author, feedback from a group of Masters level business students, and supported by literature, the author is of the opinion that the e-portfolio could be implemented in the work place as one tool to add value for individuals and organisations. Key benefits included that it stimulated reflection (self-reflection and critical thinking); assisted to assess current goals and plan future goals; guided career management, personal and professional development; and improved technological skills.

This article represents feedback from the particular group, time and place and the insights gained cannot be blindly extrapolated and generalised to all areas of business and all other employees. However, the principles are applicable.

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BOARDS CHARACTERISTICS, AUDIT COMMITTEE, EXTERNAL AUDITOR AND EARNINGS MANAGEMENT: CHINESE EVIDENCE

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Abstract

This study investigates the effect of two-tier board characteristics, audit committee, and external auditors on earnings management in China. This study contributes to the empirical literature of corporate governance in China that remarkably differs from the Anglo-Saxon structure in terms of boards' features and auditing. Using a sample of 622 listed Chinese company-years, this study finds that independent directors on the board of directors are negatively related to earnings management while employee supervisors on the supervisory board are not related to earnings management. The results of empirical analysis also show that the presence of audit committees and the brand auditors are negatively associated with earnings management. Finally, the relationship between qualified audit opinions and the level of earnings management are examined. The results show that qualified audit opinion is associated with a higher level of earnings management. Implications of these findings are discussed with regard to the characteristics of corporate governance and auditing settings in Chinese listed companies. In particular, higher proportion of independent directors on the board can improve the quality of reported earnings. However, it indicates that the role of supervisory board to restrain earnings management is limited with the increase of employee members. In addition, the existence of an audit committee improves the quality of reported earnings. Moreover, external audit play a monitoring role in mitigating earnings management in Chinese listed companies.

Keywords: Earnings management; Board characteristics; Supervisory Board; Audit committee; Auditor

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1. Introduction

China's economic reform has resulted in the corporatization and stock exchange listing of many enterprises that were previously state owned, making the Chinese capital market one of the largest capital markets in the world. This economic reform, along with the opening up of the capital market to foreign investors, has raised the demand for the establishment of an international corporate governance framework by both domestic and foreign investors. In response to this demand, in recent years, the Chinese government has strengthened the auditing profession and stipulated a new set of domestic accounting standards, which are compatible with International Financial Reporting Standards (IFRS). With the limitation to directly acquire company's information from other public sources, the reliability of accounting information provided by the Chinese capital market is becoming an interesting field.

Recently, both researchers and practitioners have realised the importance of effective monitor mechanism over management in ensuring the quality of accounting earnings. The studies of corporate governance regimes in achieving higher earnings quality have triggered a growing interest in academic research by linking corporate governance measures with earnings quality (e.g. Firth et al., 2007; Peasnell, et al., 2005; Petra, 2007; Vafeas, 2005). Chinese listed companies have several unique governance characteristics which are distinct from Western counterparts in U.S. and U.K. Accordingly, the study of Chinese corporate governance regime and its role in monitoring earnings management has implications that cannot be drawn from studies of Western listed companies.

China's corporate governance presents a number of unique characteristics. According to Chinese Company Law, listed companies are required to have a two-tier board system: a board of directors and a supervisory board. The board of directors is selected by shareholders and set up in a similar way to those boards in U.S and U.K. The supervisory board is elected by shareholders in the general meeting or the labour union being consisted of shareholders, employees and representatives from the government

that this monitoring mechanism is vacant in Anglo internal governance systems. Secondly, according to the China Securities Regulatory Commission (CSRC), unlike in Western counterpart that audit committee is prevailing, it is voluntary to set up the audit committee in Chinese listed companies. Thirdly, auditor concentration in China is far lower than in U.S and many other countries as China's auditing market is a young professional market. In addition, Chinese domestic auditing firms tend to be small size and lack of professional auditors.

Using a sample of 158 publicly traded Chinese companies and abnormal accruals as proxy of earnings management, this paper examines whether the magnitude of abnormal accruals is related to such unique governance characteristics. In particular, this paper examines the role of boards, the existence of audit committees, and external auditors in monitoring earnings management. This study finds the independence of board can constrain the earnings management. However, contrary to the CSRC's intent, the presence of employee supervisors on the supervisory boards does not effectively exert their monitoring roles in constraining earnings management. In addition, this study explores whether the existence of an audit committee on a voluntary basis could mitigate the earnings management. The empirical results show a significantly negative association between abnormal accruals and the existence of an audit committee. This result indicates that the audit committee is preferred to be mandatory rather than optional for a better governance mechanism under Chinese reporting context.

Since the effectiveness of internal governance is embedded within the larger governance process, this study also examines whether external auditors have an effective influence on constraining earnings management. The results show that "brand" audit firms (Big 4 audit firms) are negatively associated with abnormal accruals. The qualified audit opinions are positively related to abnormal accruals. These findings support the hypotheses that large and more independent audit firms play a positive role in mitigating earnings management, while qualified audit reports are a powerful evidence of low quality of accounting earnings.

This paper makes several contributions to the governance setting in Chinese reporting environment. This study performs a unique experimental analysis of Chinese listed companies. While previous studies examine either companies committing egregious financial fraud (e.g. Dechow et al., 1996; Beasley, 1996) or companies with incentives to overstate earnings (e.g. Teoh et al., 1998; Parker, 2000), this study conducts analysis on a sample of large, publicly traded Chinese companies with unique governance characteristics that cannot be observed in most Anglo-Saxon developed countries. Thus the results of this study can be used as empirical evidence to provide suggestions to regulatory body about aspects of governance mechanisms which can improve China's corporate governance practices. Moreover, this paper also contributes to the growing literature on discussing China's auditing practices. The empirical results show that China's domestic auditing profession with limited size and expertise do not effectively oversee listed companies' financial status whilst international and brand name auditors are more skilful and play a role in constraining earnings management. These findings also have policy implications for improving the efficiency of China's professional training and practices by auditing professional body. Government enforcement alone is not sufficient to improve corporate governance practices. Instead, features typically found in developed countries such as higher proportion of independent directors on the board, highly self-regulated external auditing services, and efficient monitoring ability of audit committee are playing a crucial role in mitigating earnings management and more importantly in constructing the best corporate governance practices in Chinese reporting environment.

The structure of this paper is as follows: section 2 reviews the previous studies on corporate governance and develops the research hypotheses. Section 3 details methodology and research model used in this study. The sample and data are provided in section 4. Section 5 reports the empirical results. Section 6 provides the conclusions of this paper.

2. Literature review and hypothesis

Previous studies have investigated the role of corporate governance in restraining or mitigating earnings management. Not only do a number of studies examine why and how managers manipulate earnings, but also is there a large body of literatures that identify factors which may help to mitigate earnings management. Among of these studies some focus on the roles of independent directors, audit committee, and external auditors on corporate governance.

The effective monitoring role by outside directors in managerial behaviour originates from the design of incentive contracts for executives undertaken in the study by Fama and Jensen (1983). The study has pointed out that outside directors are motivated to work in the best interests of the minority shareholders as they bear substantial reputation costs if they fail in their duties. Karamanou and Vafeas (2005) have found that U.S. companies which have a high proportion of outside directors have higher financial disclosure quality. The study by Ajinkya et al. (2005) has shown that U.S. companies that have a high percentage of outside directors are more likely to make earnings forecasts and these forecasts are more accurate and give useful information to investors. Using data of Canadian companies, Park and Shin (2004) have found that independent directors are able

to prevent earnings management if these directors have accounting or financial expertise. In China, enterprise reforms have required companies to adopt Western-style boardroom structures to improve the companies' governance capacity. In 2001, the Guideline for Corporate Governance of Listed Firms issued by CSRC requires all listed companies to have at least two independent directors and this number increased to one-third of the boards in 2003. The apparent premise under such a movement is that independent directors can, in fact, effectively serve their monitoring role in Chinese companies' decision making as shown from the experience of Western counterparts. Hence, it is suggested boards which are structured to be more independent of the management are more effective in monitoring the corporate financial reporting process. Thus the proposed hypothesis 1a is:

Hypothesis 1a: The proportion of independent directors on the board of directors is negatively related to earnings management.

Given that very few countries have two-tier boards which include the board of directors and supervisory board, their impact on governing earnings management has not been extensively examined in previous studies. One view, perhaps the majority view, argues that the settings of supervisory board can reduce agency costs and allow shareholders to monitor managers more effectively (Lipton & Rosenblumt, 1991). According to Lipton and Rosenblumt (1991), companies with two-tier boards are less concerned with or affected by current earnings and are therefore better able to oversee management's behaviour than unitary boards. Kaplan (1994) supports the claim that supervisors in Germany companies might be more independent than U.S. outside directors, especially when the supervisory board has employee supervisors. Roe (1993) also supports such argument and has pointed out that, unlike U.S. board members, employee supervisors are not appointed or dominated by CEOs. In contrast, opponents argue that the two-tier boardroom structure would entrench managers and employees at the expense of shareholders. Employee supervisors, allied with senior managers, may utilize their relationship to secure the short-term interests and keep dumbness even the company report overstated profits to the public investors (Edwards et al., 2000). Others point out that the supervision of the supervisory board is a mere formality. For example, in a Chinese setting, Tam (1995) has surveyed China's governance system and the results show that supervisory boards in Chinese companies are the nominal structure and unable to perform their duties.

According to China's Company Law (1993), the supervisory board of listed companies should have at least three members and all of them are elected by the general meeting or labour union. Among these members, at least one third of them should be employees of the company, and at least one represents the minority shareholders. Directors and managers of the company are illegal to become members of the supervisory board. This legal setting suggests that more employee supervisors on the board would serve better governance function. Consistent with majority view and Chinese corporate settings, this study deems that employee supervisors are more likely to perform their monitoring role compared with shareholder supervisors. Since the employee supervisors have a similar role to that of the independent directors played in U.S. companies, this study formulates hypothesis 1b:

Hypothesis 1b: The proportion of employee supervisors on the supervisory board is negatively associated with earnings management.

Generally, an effective audit committee improves the quality of accounting information from two aspects. First, by coordinating external and internal audits, the committee can ease external auditors' pressure and protect external auditors' independence (McMullen, 1996). Second, by monitoring companies' accounting activities, it can constrain the manipulation of earnings and maximise the possibility of discovering financial fraud. Many studies tend to highlight a negative relation between the independence or expertise of the audit committee and the magnitude of earnings manipulation. Klein (2002) finds that there is a negative association between audit committee independence and earnings management. The study also suggests that reductions in board or audit committee independence are accompanied by large increases in earnings management. Choi et al. (2004) find that if members of the audit committee hold shares in the company, they have less incentive to prevent earnings manipulation. Therefore, the results of their study demonstrate that the independence of committee members is a significant factor in performing the duties of the audit committee. Similarly, Collier and Gregory (1999) also show that an independent and well-structured audit committee is able to restrict earnings management more effectively. Bedard et al. (2004) suggest that the U.S. companies with 100% independent audit committee and with at least one financial expert on the audit committee are negatively associated with earnings management.

Audit committee have been established in China's listed companies after 2002 following the issuing of the Code of Corporate Governance for Listed Companies in China by CSRC. Although they now tend to be present in the large companies, their creation still remains as a voluntary decision of the companies, and no explicit legislation exists regarding the existence of the audit committee. However, CSRC has defined missions and the role of audit committees as a parallel to the U.S. model. The Code of Corporate Governance for Listed Companies in China (2002)

states that the audit committee should: (1) monitor the company's internal control system; (2) inspect the company's financial information and its disclosure; (3) review the internal audit system and its execution; (4) recommend the engagement or replacement of the company's external auditors; and (5) coordinate the internal and external audits. Since there is no previous studies examine the role of Chinese audit committees in earnings information, the effectiveness of the committee on monitoring earnings manipulation is thereby expected to be examined by this study. The hypothesis 1c is then developed:

Hypothesis 1c: The existence of an audit committee is expected to be associated with less magnitude of earnings management.

The quality of the external audit, unobservable to the public, is generally proxied by auditors' reputation or their size. In contrast with the scandals that challenge the credibility of famous audit firms, many studies tend to assert that the brand audit firms (e.g. Big 4) are more conservative in issuing their opinions, and are more likely to restrict opportunistic accounting activities. Earlier study conducted by DeAngelo (1981) has found that auditors with more clients have greater incentives to monitor and inspect their clients' financial reports. The reason is that if auditors cannot act independently and find out material earnings manipulation or other financial fraud, they would have a high risk to loss their reputation and licences or even get a heavy punishment. Kim et al. (2003) in their recent study also find that the large accounting firms (e.g. Big 4) are likely to enhance the credibility of financial reports to a greater extent than non-Big 4. However, some other researchers argue that not all types of earnings management receive the same scrutiny by different size auditors. In a survey of auditors at large international accounting firms, Nelson et al. (2002) find that auditors are less likely to require adjustments to structured accounting transactions that they believe represent attempts at earnings management when the accounting for those transactions is regulated by precise accounting standards. It is also reported in this survey that auditors are more likely to require adjustments to transactions which they believe are material. Therefore Nelson et al. (2002) argue that even though the external audit function serves to mitigate earnings management, its effectiveness varies with the characteristic of the transaction.

In China, the auditing professions are markedly different. After the revolution in 1949 the role of external auditing in the Chinese planned economy diminished significantly and was completely abolished when the economy was fully nationalized in 1962 (Gensler & Yang, 1996). Therefore, in time of planned economy auditing bodies became one of the Government agencies and played a role as an internal auditor of the Government. Until 1978, after the economic reforms, the state-owned enterprises were decentralized and foreign investment grown rapidly that created demands for external audits for decision making and tax collection purposes. Partially in response to the needs for external auditing services the Ministry of Finance created the Chinese Institute of Certified Public Accountants (CICPA) in 1988 and granted permission to select some governments' accounting organizations to audit public companies after opening the stock exchanges in Shanghai and Shenzhen. However, due to lack of capital, new auditing firms have to affiliate with former existing institutions. Such generation process gives the Chinese auditing professions three distinctive features: government ownership of audit firms; limited size of audit firms; and the lack of experienced and independent auditors.

This study investigates the implication of characters on Chinese auditing professions compliance with studies undertaken in Western counterparts and thereby assumes that compared with smaller and previously government owned audit firms, larger and brand name audit firms can provide higher quality audit services and have lower tolerance towards earnings management in general. Using Chinese data, DeFond et al. (2000) in their study have found that managers are more likely to prefer smaller auditors because they consider that small auditors allows them to have more flexibility reporting their earnings. Firth et al. (2007) also point out that audit concentration in China is far lower than that in U.S. and that directly results in compromised level of auditing qualities. To summarize the above analysis, this study adopts international brand name firms - Big 4 as the large audit firms and expects that there shall be negatively relationship between the level of earnings management and Big 4 audit firms.[1] Hence, the following hypothesis 2a is developed:

Hypothesis 2a: Big 4 audited companies are negatively associated with the level of earnings management.

Audit opinion, which is the main outcome of their work by external auditors, shall reflect the actual financial situation of a company. However, the evidence on the association between earnings management and audit opinions is rare. The most closely related studies are Francis and Krishnan (1999) and Bradshaw et al. (2001) who examine the association between total accruals and audit opinions. Francis and Krishnan (1999) find that other factors being equal, auditors are more likely to issue qualified audit reports for companies with high-accruals. They argue that because accounting accruals are the estimates of future outcomes and have relatively high uncertainty, audits of high-accrual companies' exhibit greater risk than audits of low-accruals companies. Conservatively, auditors would rather issue qualified audit opinions to their clients. With a slightly different

rationale, Brasdhaw et al. (2001) find that companies with high accruals are associated with lower possibility of qualified opinion. The reason is that auditors are poor users of accruals information and usually fail to communicate to investors' problems arising from high-accruals reporting with respect to future earnings. In China, listed companies fear to report poor performance to the public and receive qualified audit opinions. That is because bad performance and qualified opinions might result in costly penalties by CSRC (e.g. delisted). And more importantly, those results are associated with stock price declines (Chen et al., 2000). If companies make consecutive losses, there is high possibility that mangers might make great efforts to overstate the earnings and makeup their performance. External auditors as independent bodies, have the responsibilities to restrict and detect such behaviour. And as the effort of restriction, they would issue qualified audit opinions as a caution for public investors. Chen et al. (2001) have found that earnings management in Chinese companies increases the frequency of receiving qualified audit opinions. DeFond et al. (2000) using Chinese data has indirectly proved this point of view. They find that after issuing more rigid auditing standards, qualified audit opinions are more frequently issued by Chinese auditors. Linking the governing role of external auditors to their audit opinions, this study believes that qualified audit opinions will be positively correlated with abnormal accruals. This study then formulates the following hypothesis 2b:

Hypothesis 2b: Qualified audit opinions is positively associated with the level of earnings management

3. Measurement of earnings management and the model

The proxy for earnings management in this study is abnormal accruals. Although companies might have some other ways to manipulate earnings, such as cutting maintenance costs on equipment, selling idle assets, or reducing expenses on research and development, these alternative actions are costly and have negative effects on companies' future cash flows (Peasnell et al., 2005). With Western countries' experience, this study assumes that in China manipulation of accruals is likely to be the most popular instrument for opportunistic earnings management.

To maximize the sample size and avoid the survivorship bias problem inherent in the time-series approach (Becker et al., 1998), this study estimates abnormal accruals using the cross-sectional Jones (1991) model.[2] Industries are classified according to the ANZSIC codes (Australia codification roughly similar to the U.S. SIC one). The Jones model coefficients are estimated using the following OLS regression:

$$\frac{TA_{ik,t}}{A_{ik,t-1}} = \beta_{1k,t}\frac{1}{A_{ik,t-1}} + \beta_{2k,t}\frac{\Delta REV_{ik,t}}{A_{ik,t-1}} + \beta_{3k,t}\frac{PPE_{ik,t}}{A_{ik,t-1}} + e_{ik,t} \quad (1)$$

where $TA_{ik,t}$ is total accruals for company i in industry k in year t, $A_{ik,t-1}$ is total asset in the year t-1, $\Delta REV_{ik,t}$ is the change in revenue, $PPE_{ik,t}$ is the gross property, plant and equipment, $\beta_{1k,t}$, $\beta_{2k,t}$, and $\beta_{3k,t}$ are regression coefficients, and $e_{ik,t}$ (assumed i.i.d.) is the regression residual.

For each industry-year ik, t in the Chinese sample, abnormal accruals ($AA_{ik,t}$) is calculated with the following formula:

$$AA_{ik,t} = \frac{TA_{ik,t}}{A_{ik,t-1}} - \left(\hat{\beta}_{1k,t}\frac{1}{A_{ik,t-1}} + \hat{\beta}_{2k,t}\frac{\Delta REV_{ik,t}}{A_{ik,t-1}} + \hat{\beta}_{3k,t}\frac{PPE_{ik,t}}{A_{ik,t-1}}\right) \quad (2)$$

where $\hat{\beta}_{1k,t}$, $\hat{\beta}_{2k,t}$, and $\hat{\beta}_{3k,t}$ are OLS regression estimates of $\beta_{1k,t}$, $\beta_{2k,t}$, and $\beta_{3k,t}$ respectively, and obtained from equation (1). Since the analysis does not depend on the direction of the accruals but on the magnitude of the accruals, this study therefore uses absolute value of abnormal accruals as the proxy for the combined effect of income-increasing and income-decreasing earnings management. Other studies using this measure are Bartov et al., 2000, Becker et al., 1998, Firth et al., 2007, Klein, 2002, and Warfield et al., 1995.

Table 1 reports descriptive statistics for total and abnormal accruals. Of the 800 company-years initially targeted, this study obtains 622 usable observations. Abnormal accruals range from -2.1911 to 0.949 with a median of 0.0082. The average abnormal accrual is 0.0041. Testing for whether the mean abnormal accrual is different from zero outputs a p-value of 0.4737 and a sign test yields 56% of abnormal accruals are positive. This means that there is no evidence showing that the earnings management behaviour has a systematically increasing or decreasing trend. This finding reflects that the selected sample is a relatively random sample with respect to earnings management incentives. Because of this quality, using the absolute value of abnormal accruals as the proxy of earnings management is appropriate in China's context and is also supported by other literature (e.g. Bartov et al., 2000; Becker et al., 1998; Firth et al., 2007; Warfield et al, 1995).

Insert Table 1 about here

After calculating the abnormal accruals, the effect of board structure and external auditor on earnings manipulation could be examined by regression

models. This study adopts the cross-sectional pooled regression method to examine whether boards independence and auditor independence reduces earnings management. The regression model is as follows:

$$AA_{it} = \alpha_0 + \delta_1 BOARD_{it} + \delta_2 SUPERVISORY_{it} + \delta_3 AUDITCOMMITTEE_{it} + \delta_4 BIG4_{it} + \delta_5 QUALIFIED_{it} + \gamma_1 LSIZE_{it} + \gamma_2 LEVERAGE_{it} + u_{it} \quad (3)$$

where $BOARD_{it}$ represents the proportion of independent directors on the board of directors; $SUPERVISORY_{it}$ denotes the proportion of employee supervisors on supervisory board; $AUDITCOMMITTEE_{it}$ is an indicator variable taking the value of one if the company has an audit committee, zero otherwise; $BIG4_{it}$ is an indicator variable taking the value of one if the company is audited by Big 4 accounting firms during the observation period and zero otherwise. QUALIFIED is another indicator variable taking the value of one if the company received a qualified audit opinion, zero otherwise.

In addition to the experimental variables, it is necessary to control for other factors that have been shown to affect the earnings-returns relation. Consistent with other studies (e.g. Firth et al., 2007; Klein, 2002; Xie et al., 2003), this study uses the natural logarithm of the net sales (LSIZE) and leverage ratio (LEVERAGE) to control for the influence of company size and capital structure respectively. China's larger companies are usually followed actively by the external capital markets. Therefore, larger listed Chinese companies are less likely to be able to hide abnormal accruals than smaller companies. Accordingly, this study expects that the company size has a negative association with abnormal accruals. The intensity of conflicted interests between debtors and shareholders increase when financial leverage rises. Generally, the higher the leverage ratio, the greater the risk that some debt covenants would be breached and the higher cost of debt financing. Similarly, in China, as debt increases, listed companies may tend to adjust earnings upwards in order to avoid debt-covenant violation and an increase in financing cost. DeAngelo et al. (1994) using the U.S. sample has reported that companies manipulate earnings when they face binding debt covenants. This study using Chinese data to expect that a positive relation should be observed between abnormal accruals and leverage ratio.

4. Sample and Data

The analysis is based on the information from Chinese listed companies over a four-year period from 2004 to 2007. Board data, audit committee data, and external auditor data are collected from annual reports issued by companies to the Shanghai or Shenzhen Stock Exchange. The final observation has a total of 622 company-years. The minimum number of observations for any given industry-year combination is 8. The sample company-year is selected only when detailed information on directors, supervisors, and auditors are available in the annual reports. In line with other studies (e.g. Firth et al., 2007; Klein, 2002; Park & Shin, 2004; Peasnell et al., 2005) this study excludes companies in the financial sector because of the difficulties of defining accruals and abnormal accruals for financial services. Table 2 summarizes how the final sample is constructed.

Insert Table 2 about here

Consistent with prior research (e.g. Chen et al., 2006; Firth et al., 2007; Peasnell et al., 2005), this study classifies directors as independent or non-independent directors.[3] Independent directors have no ties to the company beyond being a board member. Non-independent directors are the current employees of the company or the directors of non-executive but having significant transaction or business relationships with the company. According to the Code of Corporate Governance for Listed Companies in China, supervisors in this study are classified into employee supervisors and shareholder supervisors. Because foreign accounting firms can not directly provide auditing services for Chinese domestic companies, this study recognizes the Chinese accounting firms that have joint venture with the international Big 4 as the brand name audit firms. Audit opinions in China can be classified into four categories: unqualified, qualified, disclaimer, and adverse (similar with U.S.). Because this study investigates the effect of qualified or unqualified audit opinions on earnings managements, disclaimer or adverse opinions are thereby excluded from the sample. Companies that receive disclaimer or adverse opinions have been removed from the samples (see table 2).

Panel A of Table 3 shows governance characteristic of the sample companies. On average, 35% of board members are independent. In addition, employee supervisors have average 37% of total supervisory board seats, and the rest are shareholder supervisors. Although compositions vary from company to company in the sample, these percentages are consistent with CSRC's requirements that at least one third of directors should be independent and at least one third of supervisors should be employees. The total number of audit committees increases from 68 in 2004 to 144 in 2007. This trend indicates that more Chinese listed companies have a motivation to constitute an audit committee voluntarily. Nevertheless, only 37% of financial statements are audited by Big 4. This figure proves that audit concentration is still low in China. Moreover, there are 25 sample received qualified audit opinions during the sample periods. This number indicates that the number of Chinese companies who received qualified

opinions is relatively low. Panel B of table 3 reports the descriptive statistics of experimental variables.

Insert Table 3 about here

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5. Empirical Results

5.1 Univariate models

Table 4 provides the univariate least square regression results with abnormal accruals as the dependent variable and overall governance characteristic variables as the independent variables. As expected, this study finds that the percentage of independent directors is negatively related to the abnormal accruals at the 5% level and the presence of an audit committee also has a negative association with abnormal accruals at the 1% level. The coefficient on employee supervisors exhibits positive but insignificant. This result is contrary to the hypothesis that employee supervisors could constrain the earnings management. Considering outside auditors, abnormal accruals are negatively associated with Big 4-audited companies ($p < 1\%$) and positively associated with those companies who receive the qualified audit opinions ($p < 1\%$). These findings are consistent with the hypotheses and confirm that external auditors could serve to mitigate earnings management in Chinese context. In the following section, this study adds some multivariate analyses to further testify these findings.

Insert Table 4 about here

5.2 Multivariate models

Table 5 reports multivariate least square regression results on internal governance. Column (i) and (iv) of table 5 contains combined variables intended to capture the characteristics of director independence. The estimated coefficients on the percentages of independent directors on the board are significantly negative at the 5% and 10% levels, respectively. These findings are consistent with univariate testing result. Thus, in Chinese context, board composition is related to abnormal accruals and indicates the setting in which a large proportion of independent directors is associated with better monitoring. However, contrary to the expectation of the role of employee supervisors in earnings management, there appears to be no meaningful relations between abnormal accruals and the proportion of employee supervisors on supervisory board. Combining the results of univariate and multivariate analyses, this study argues that employee supervisors cannot serve to mitigate earnings management in China's governance system. This finding might reflect the situation that in China, employee supervisors may have a lack of independence and affiliated with companies' management or local government. As explained by Dahya et al. (2003), Chinese supervisors usually play the role of honoured guests or friendly advisors, while few of them can play the role of independent directors. In addition, the association between abnormal accruals and the existence of an audit committee is highly significant according to column (iii) and column (iv) of Table 5. These results confirm the result of univariate result that the presence of an audit committee can mitigate earnings management. It can be seen that since China adopted a voluntary-based audit committee policy in 2002, Chinese shareholders have realized the importance of sub-committees and utilized their monitoring role to constrain manager's financial fraud or earning manipulation. More recent information releases from CSRC also confirms such cognition. In July 2009, CSRC abandoned the voluntary policy and required all listed companies must set up the audit committee.[4]

Insert Table 5 about here

Regarding the audit quality variables, table 6 reports the multivariate results. As predicted, this study obtains significantly negative coefficients for big auditor definition ($p < 10\%$) and significantly positive coefficients for qualified opinion definition ($p < 5\%$). These results are consistent with univariate analysis. Thus, the overall tests on external auditors supports that international Big 4 audit firms in China are statistically able to constrain opportunistic accounting practises and could maintain the audited companies to have a lower level of abnormal accruals. Moreover, these results also demonstrate that Chinese companies with qualified audit opinions maintain a high level of earnings management. This finding indicates that audit firms (both Big 4 and non-Big 4) are conservative in their opinions if they find unexpected earnings management occurred with the audited companies. Due to the rigorous and complex legal environment, they are more likely to resist managerial pressure and issue prudential opinion. Consistently, this finding supports Chen et al.'s (2001) standpoint which is that qualified audit opinion were the evidence of low quality earnings while contrary to Brasdhaw et al.'s (2001) point of view who argue that external auditors are the poor users of accrual information.

Insert Table 6 about here

Finally, both table 5 and table 6 report the results for control variables. The overall sign of control variables are consistent with the expectation. The estimated coefficients on company size are negative and significant ($p < 1\%$) in all the regressions, consistent with the notion that larger Chinese companies are more closely scrutinized than smaller companies. However, the coefficients on capital

structures are only significant in column (i) of table 5 and table 6 ($p < 5\%$), indicating Chinese companies tend to increase their earnings when they face a high debt-to-equity ratio but due to the lenders' monitoring, the intensity has been controlled.

5.3 Additional tests

To check the sensitivity of findings, this study re-estimates abnormal accruals using modified-Jones model (Dechow et al., 1995). This 'modified' Jones model is deemed to be more powerful at detecting sale-based accruals than the Jones model. Many previous studies adopt this methodology (e.g. Bartov et al., 2000; Firth et al., 2007; Kothari et al., 2001; Xie et al., 2003). The abnormal accruals are calculated using the following regression:

$$AA_{ik,t} = \frac{TA_{ik,t}}{A_{ik,t-1}} - \left(\hat{\beta}_{1k,t} \frac{1}{A_{ik,t-1}} + \hat{\beta}_{2k,t} \frac{\Delta REV_{ik,t} - \Delta REC_{ik,t}}{A_{ik,t-1}} + \hat{\beta}_{3k,t,} \frac{PPE_{ik,t}}{A_{ik,t-1}} \right) \quad (4)$$

Compared with the equation (2), the revenue changes ($\Delta REV_{ik,t}$) in equation (4) are adjusted by the changes of receivables ($\Delta REC_{ik,t}$). This modification is designed to eliminate the conjecture tendency of the Jones Model to measure abnormal accruals with error when managers exercise discretion in manipulating earnings through revenue recognition (Dechow et al., 1995). Using equation (4) as the measure of abnormal accruals, this study follows the same methodology described in Section 3 and calculates an AA for every company-year. The univariate and multivariate results with specification are almost identical to those reported in the table (4), table (5), and table (6). Table 7 contains the estimated coefficients and p-values for both tests.

Insert Table 7 about here

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6. Conclusion

This paper examines whether board characteristics, audit committee, and external auditors are related to earnings management by Chinese listed companies. The motivation behind this paper is the implicit assertion by the CSRC that best corporate governance practices would mitigate earnings management. As China's listed companies have distinctive governance structures and China has an embryonic auditing market, this paper, in particular, analyses whether independent directors, employee supervisors, the presence of audit committee, brand name auditors, and auditing reports are associated with earnings management.

Empirical tests use data in the annual report of Chinese listed companies from 2004 to 2007. Abnormal accruals are considered in absolute value as the proxy for the magnitude of earnings management. This study finds that abnormal accruals are negatively associated with board independence. The employee supervisors have negative effect on accruals measurements. However, this influence is not significant. Also, the presence of an audit committee is found to contribute to a lower level of abnormal accruals. Big 4-audited companies are observed to be associated with a lower level of earnings management. Finally, this study finds that companies received qualified audit opinions have a high possibility to manipulate reported earnings.

These findings contribute to the debates on financial reporting quality regarding the role of independent directors, employee supervisors, audit committees, and the status of external auditors in China. A greater proportion of independent directors on board can improve the earnings quality. Nevertheless, the findings challenge the monitoring role of employee supervisors on the supervisory board. Are they competent to monitor earnings management? Do they have incentives monitoring management's decision about reported earnings in the annual report? These questions need to be further addressed. Audit committees servicing as the part of monitoring mechanism, in China's governance environment, seem to function quite well in terms of their roles to improve the quality of accounting information. Therefore, CSRC has recently announced that listed companies should have audit committees. However, the duties and responsibilities of committees' members need to be further specified. Otherwise, any future recommendations on audit committee are likely to be sterile. Furthermore, Big 4 auditors provide quality-differentiated auditing services with respect to accounting earnings. This is also an indication that in China, brand name auditors are exposed to deep pockets incentive and they have to deal with the threat by adopting more prudential activities with respect to earnings management. Finally, the positive relation between abnormal accruals and qualified opinions illuminates that overall Chinese auditors are quite conservative when they find unexpected earnings management. Another implication derived from this finding is that for the purpose of improving auditing quality, Chinese policy-makers should adopt more rigorous auditing standards and continuous professional training.

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Notes

[1] Some other studies (e.g. Chen et al., 2001; Qiu, 2004) use Big 10 classification (auditors with the 10 highest markets shares) as the proxy of large and high quality auditors in China.

[2] Other papers using this model include Becker et al., 1998; Defond & Jianbalvo, 1994; DuCharme et al., 2001; Peasnell et al., 1998; Teoh et al., 1998.

[3] According to the NYSE listing requirements, directors are classified into three categories: insiders, outsiders, or affiliated with the company. Papers for example, using this classification include Brickley et al., 1994; Byrd & Hickman, 1992; Klein, 2002; and Xie et al., 2003.

[4] In July 2009, China Securities Regulatory Commission released the Basic Internal Control Norms for Enterprises. And according to it all the listed Chinese companies must establish an audit committee and non-listed companies are still maintain a voluntary base.

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Appendices

Tables

Table 1.

Descriptive statistics on accruals, and abnormal accruals

Variable	*Mean (P-value)*	*Median*	*Min*	*Max*	*Std. dev.*	*Obs.*
Abnormal accruals (AA)	0.004(0.474)	0.0082	-2.1911	0.949	0.1427	622
Abs[a](AA)	0.0694	0.0414	0.0000	2.1911	0.1247	622
Total accruals (TA)	-0.046	-0.0431	-2.3668	0.9939	0.1554	622
Abs[a](TA)	0.0858	0.0569	0.0002	2.3668	0.1375	622
Net profits[b]	0.0531	0.0428	-0.4067	0.479	0.08	622
Operating cash flows[c]	0.0991	0.0858	-0.963	2.2291	0.1604	622

[a] Abs is the absolute value.
[b] Net profits are from the income statements deflated by lagged total assets.
[c] Operating cash flows are from the cash flows statements deflated by lagged total assets.

Table 2

Sample used in analyses

	Company-years
Initial sample for 2004-2007	800
Insufficient industry-year observations	(64)
Banking companies	(36)
Insurance companies	(28)
Missing financial reports	(32)
Missing data on boards' characters	(10)
Companies received disclaimer or adverse audit opinions	(8)
Final sample	622

Table 3

Descriptive corporate governance data

Panel A: Sample characteristics						
	2004	*2005*	*2006*	*2007*	*Total*	*%*
Independent directors	547	557	554	560	2218	0.35
Non-independent directors	1065	1062	1046	1034	4207	0.65
Employee supervisors	240	243	246	249	978	0.37
Shareholder supervisors	425	424	417	420	1686	0.63
Audit committee	68	68	75	144	355	0.57
Audit by international Big 4	59	57	56	55	227	0.37
Unqualified audit opinions	145	150	149	153	597	0.96
Qualified audit opinions	8	5	7	5	25	0.04
Obs.	153	155	156	158	622	-
Panel B: Descriptive statistics on experimental variables						
	Mean	*Median*	*Min*	*Max*	*Std. dev.*	*Obs.*
BOARD[a]	0.3482	0.3333	0.13	0.556	0.0469	622
SUPERVISORY[b]	0.3691	0.3333	0	0.667	0.0796	622
AUDITCOMMITTEE[c]	0.5707	1	0	1	0.4954	622
BIG 4[d]	0.365	0	0	1	0.4818	622
QUALIFIED[e]	0.0402	0	0	1	0.1966	622

[a] BOARD is the proportion of independent board members.
[b] SUPERVISORY is the proportion of employee supervisors.
[c] AUDITCOMMITTEE is a dummy variable equal to one if the company has an audit committee and zero if otherwise.

[d] BIG 4 is a dummy variable equal to one if the company is audited by a Big 4 auditor and zero if otherwise.
[e] QUALIFIED is a dummy variable equal to one if the company receives a qualified audit opinion and zero if otherwise.

Table 4

Univariate models of absolute values of abnormal accruals (AA) on overall corporate governance variables

Variable	*Expected sign*	*Coefficient (P-value)*	*Coefficient (P-value)*	*Coefficient (P-value)*	*Coefficient (P-value)*	*Coefficient (P-value)*
BOARD	-	-0.086 (0.0416)**				
SUPERVISORY	-		0.0961 (0.1917)			
AUDITCOMMITTEE	-			-0.0097 (0.0078)***		
BIG 4	-				-0.02289 (0.00)***	
QUALIFIED	+					0.0441 (0.0001)***
INTERCEPT		0.0993 (0.00)***	0.0358 (0.178)	0.07493 (0.00)***	0.0777 (0.00)***	0.0676 (0.00)***

The pooled sample provides 632 observations with 10 missing data, representing 158 companies or clusters. The White Cross-section or Cross- section SUR (PCSE) method is used to correct cross-sectional heteroskedasticity and correlated period effect.
* Significant at a level of 10%; ** Significant at a level of 5%; *** Significant at a level of 1%

Table 5

Multivariate tests of absolute values of abnormal accruals (AA) on internal governance variables

		(i)	*(ii)*	*(iii)*	*(iv)*
Variable	*Expected sign*	*Coefficient (P-value)*	*Coefficient (P-value)*	*Coefficient (P-value)*	*Coefficient (P-value)*
BOARD	-	-0.0929 (0.0213)**			-0.1043 (0.0741)*
SUPERVISORY	-		-0.0024 (0.9263)		0.0042 (0.8812)
AUDITCOMMITTEE	-			-0.0086 (0.0016)***	-0.0089 (0.0005)***
LSIZE	-	-0.0091 (0.00)***	-0.0091 (0.00)***	-0.0091 (0.00)***	-0.009 (0.00)***
LERVERAGE	+	0.0229 (0.0181)**	0.0217 (0.1813)	0.0192 (0.2367)	0.0206 (0.2201)
INTERCEPT		0.2245 (0.00)***	0.1947 (0.00)***	0.0641 (0.00)***	0.0982 (0.00)***

The pooled sample provides 632 observations with 10 missing data, representing 158 companies or clusters. The White Cross-section or Cross- section SUR (PCSE) method is used to correct cross-sectional heteroskedasticity and correlated period effect.
* Significant at a level of 10%; ** Significant at a level of 5%; *** Significant at a level of 1%

Table 6
Multivariate tests of absolute values of abnormal accruals (AA) on external auditing variables

Variable	Expected sign	*(i)* Coefficient (P-value)	*(ii)* Coefficient (P-value)	*(iii)* Coefficient (P-value)
BIG 4	-	- 0.0098 (0.0799)*		-0.011 (0.0832)*
QUALIFIED	+		0.0222 (0.0346)**	0.0238 (0.04)**
LSIZE	-	-0.0079 (0.001)***	-0.0085 (0.00)***	-0.0067 (0.0017)***
LERVERAGE	+	0.0209 (0.024)**	0.0199 (0.1981)	0.0204 (0.2159)
INTERCEPT		0.1789 (0.00)***	0.1845 (0.00)***	0.1616 (0.00)***

The pooled sample provides 632 observations with 10 missing data, representing 158 companies or clusters. The White Cross-section or Cross- section SUR (PCSE) method is used to correct cross section heteroskedasticity and correlated period effect.
* Significant at a level of 10%; ** Significant at a level of 5%; *** Significant at a level of 1%

Table 7
Estimate coefficients and p-values for univariate and multivariate models in which the AA is calculated by modified-Jones model

Variable	Expected sign	Univariate test [a] *Coefficient (P-value)*	Multivariate test [b] *Coefficient (P-value)*
BOARD	-	-0.0345 (0.0497)**	-0.0368 (0.0939)*
SUPERVIOSRY	-	0.0877 (0.2375)	-0.0049 (0.8281)
AUDITCOMMITTEE	-	-0.0106(0.0051)***	-0.0099(0.0013)***
BIG4	-	-0.0208 (0.000)***	-0.0107 (0.0585)*
QUALIFIED	+	0.0352 (0.0131)**	0.0327 (0.0078)***

[a] Univariate test is the max possibility estimates of the absolute value of abnormal accruals on the independent variable.
[b] Mulitivariate test is the max possibility estimates of the absolute value of abnormal accruals on the independent variable and other variables in Table 5 and Table 6.
The pooled sample provides 632 observations with 10 missing data, representing 158 companies or clusters. The White Cross-section or Cross- section SUR (PCSE) method is used to correct cross section heteroskedasticity and correlated period effect.
* Significant at a level of 10%; ** Significant at a level of 5%; *** Significant at a level of 1%

DEMOCRATIC CORPORATE GOVERNANCE WITHIN FLUCTUATING COOPERATIVE BANKS: A MULTIDISCIPLINARY DIAGNOSIS AND PROPOSITION OF ORIENTATIONS

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Abstract

The democratic question became of an ardent actuality within cooperative banks since the end of the 1990's. Founding element of human-sized organizations that were the first mutual or cooperative *caisses*, is democracy running the risk to dissolve by necessity in the mature and hybrid giants that are the big banking cooperative groups nowadays? The present article unveils a multidisciplinary synthesis made possible by the conjunction of three researchers studying cooperative banks through three complementary angles: law, economy and management. After a first inventory of the possible symptoms of the disappearance of democracy inherent to the cooperative project, a more differentiating diagnosis is proposed, followed by an outline of some working leads for a creative evolution of cooperative democracy.

Keywords: Democracy, bank, cooperative, pluridisciplinarity, new cooperative paradigm

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Introduction

For a decade the conservation of a specific identity of cooperative banks has raised questions. Since the rescue of capitalist banks by Crédit Agricole and Crédit Mutuel during the 1990s, the question of the cooperative "purity" of these banks has arisen in a blatant way, at least in a more visible way than it had been at the creation, during the previous decade, of private law subsidiaries. In a pioneer article, Daniel Coté had noticed, since the year 2000, that the maturity of the banking sector, with its oligopolistic concentrations, questioned the cooperative project within big mutuality banks and he called to the foundation of a new cooperative paradigm (Coté, 2000).

Some years later, a whole series of publications are dedicated, in France in particular, to the possibility of maintaining a cooperative identity while facing the competitive banking game and by diversifying its funding sources beyond the sole 'membership'. In the middle of the 2000 decade, a collective work has come to put a noticeable milestone in the study of this delicate situation between "performance and solidarity" (Richez-Battesti & Gianfaldoni, 2006). Since this date, studies and colloquiums on the subject have multiplied.

One of their most considerable characteristics is at the origin of the present work. It is about the variety of the disciplinary horizons from which arise the researchers who contribute to all these studies: law, economy, but also sociology and management sciences. We want to attempt a multidisciplinary clarification of this delicate problem of the transformation of cooperative banks, by choosing as point of view, one of the key questions of social economy: democracy. The idea of intersecting the respective approaches of an economist, a jurist and a researcher in management sciences brought about the democratic phenomenon in all its complexity, due to the plurality of threats on the reality of a cooperative democracy within the banks who refer to it, but also in the unexpected opportunities and in the evolutions which would have been necessary in any case, independently of the only institutional pressure to demutualization.

Because it is necessary "to examine" all the denotations of the term democracy, this crossed outlook is presented in three parts inspired by the medical clinic sector. In a first part, the symptoms that feed the fear of a collapse of the cooperative project are exposed. In a second part, we move from the symptoms to the diagnosis by trying to make connections between real threats and simple indications of reorganization of the cooperative idea, a diagnosis intended to supply support points in its intensification. Finally, in the third part, we attempt a

synthesis of the recommendations that seem to ensue from our previous analyses.

1. The symptoms

It is possible to find in law, as in economy and organizational life, the signs of a collapse of the cooperative project, particularly within banks. From then on, one can fear their conjunction to a radical demutualization scenario that would end in the disappearance of a major piece of the social economy.

1.1 Legal symptoms

A first ingredient of this scenario lies in the general report that the couple formed by law and cooperative ethics is changing in nature (Hiez, XXXX). Whereas in its debuts, the cooperative project was created, in a sense upstream to law, its legal recognition was gradually made, throughout the XX° century, by the incorporation of the principles of this project in law. This registration "in the hard" concern, in French law as well as in French Canadian law, (ibidem, p. 3) the double quality principle (the co-operators are partners and beneficiaries at the same time) that of a-capitalism (limitation of capital remuneration and the compulsory constitution of reserves) and of political democracy (" one man, one vote"). Now, we can only notice, through all the studies led around cooperatives for about fifteen years, the movement of a reference to the principles to that of a much more vague 'normativity' centred on cooperative "values", which accompanies the transition of a legal rules system to a system of standards.

This supremacy granted to "values" would not know how to be innocuous. Whereas the principles, without being unchanging, " evolve in a slower, less spasmodic way, than the substantive law of such or such State " (ibidem, p. 6), the standard recovers from a *soft law* which is imperative only in contractual limits, and its disregard only activates penalty recovering from action circuits and more random reactions than the malpractice against the legal rule. On that plan we can thus advance that "of a clear, unchanging and rigorous rule, we would go through to more vague, evolutionary standards, of a variable-geometry imperativeness" (ibidem, p. 8). From which the risk of a progressive nibbling of the cooperative principles, if the exceptions in the traditional principles multiply without the formulation of new principles or new orientations (ibidem, p. 9).

1.2 Economic Symptoms

At the same time we are entitled to wonder about " the normative capacity of cooperative firms in a sector-based environment, and in a more widely macroeconomic one, acquired through the principles and through market capitalist values " (Gianfaldoni, 2007: 15). So, at the governance level of cooperative banks, the logic of profitability appropriate for the private enterprise " tends to insinuate itself or to be gradually imperative " (Gianfaldoni, 2008: 4) through the following decisions, which affected more or less most of the French cooperative banks:

- External growth operations and profitability requirement of the shareholders, which accompanies a new configuration of the consequent chain with an ascent of the value created towards holding companies or quoted companies,
- Rationalization of the production of the banking services aiming at performances estimated in terms of costs and productivity gains,
- Legitimization of these logics by the banking sector regulations: law of 1984, statutory modifications of 1992, Bâle II prudential rules,
- Financial evaluation publications by rating agencies,
- Motivation of salaried directors and administrators more and more centred on financial criteria and control levers

Within the framework of a forward-looking scenario, such measures may contribute " to demutualize from the inside " the cooperative banks, by emptying of their substance the solidarities inherent to Desroches' "quadrangle" - directors, administrators, employees and members - and the institutional balances supported by this quadrangle. The relation directors-employees is affected by a tendency of the first ones to adapt the "democratic practices" to the "business practices" rather than the opposite (Gianfaldoni, 2007, p. 7), the relation employee-member aims towards a clientelism of the service relation (ibidem.). Whereas between administrators and directors, an increasing difference of technical competence can only lead to a real power asymmetry which dispossesses the members of their orientation power of the bank. Finally, the gigantic size of the mutuality banking groups can only naturally increase the distance between national administrators and members, a trend possibly increased through functions personalization and multiple office-holding (ibidem, p. 11). Finally, we can even doubt the perpetuity of this quadripartite plan, as far as the adoption of a highly-rated vehicle, introducing the fifth actor under the shape of the shareholder, comes to transform the quadrangle into a "pentagon" (Ory, Gurtner and Jaeger in Richez-Battesti and Gianfaldoni, on 2006: 99).

Would these new distributions of the technical capacity as economic naturally lead to a situation where democracy of right, with its votes and its resolutions approved in various assemblies, cover a not-democracy, reducing the statutory authorities to a pure ritual? The question is all the more acute as the ground studies show a narrow overlap between the institutional and the organisational one.

1.3 Organizational symptoms

The study of a big French cooperative banking group (Jardat, 2008a) joins partly the observations made at the same time by Daniel Coté during his research-action led at a Caisse Desjardins: the project, the cooperative principles and the values are vain if they are not conveyed in the daily practices of the organization. Daniel Coté speaks of this subject as daily "moments of truth" (Coté, 2005: 55). The example treated in France maybe read as the illustration of a narrow interaction between the expected reasons of the cooperative project on one side, realized by a much elaborated internal law, and the constraints of the organizational gigantic size on the other.

On one side, the competitive (fight for market shares within a national oligopoly of the banking network) and normative (banking regulation) pressure comes to reinforce the tendency to technocratic centralism that naturally occurs in all large organizations. The installation of information systems, the need for consolidating overall ratios of profitability and performance, just like the increasing technicality of the banking trade, can only tend to increase asymmetries of resources between the graduate and the promoted intern, the hierarchical one and the operator, the central director and the local administrator. However, sociologists have showed that for some decades, these asymmetric resources mechanically generate, in everyday life, asymmetries of power: so we see with sociologist, Anthony Giddens of the "dialectic of control in social systems" (Giddens, 1985: 64). The person who knows more, who has a wider viewpoint, whose functions bring to meet a vaster network of co-workers and exterior partners, mechanically detains a greater power. It remains to be seen whether this power is used in the direction of the collective interest, under the control of the interested stakeholders, or if it is on the contrary the opportunity to perceive material profits (incomes) or symbolic excess (recognition, prestige), in a more or less close degree of asymmetry appropriate for the private enterprise. Within the framework of a technicality and of a developing organization, everything points, *a priori*, that it is the second possibility that tends by necessity to come true, if no specific counterweight is developed.

However, on the other hand, the very elaborated power architecture of the studied bank leads to permanently counterbalance these asymmetries of power and, otherwise to realize a utopia of the full and whole democracy, at least to maintain a logic of research for the consensus which goes against the technocratic and centralist tendencies. A series of decisions as strategic and organizational non-decisions, engraved in memories, completely illustrate this assertion (Jardat, 2008a: 32-33). These formative events of common faith in opposition forces of the members as of decentralized Caisses to central directors, would not have been able to take place without strong institutional architecture which establishes, with the inertial force of the legal statuses, a balance of power between the premises and the exchange as well as amongst diverse stakeholders of the bank (ibidem: 36-38).

A contrario, we can only deduct that, without such a statutory architecture, the pressure in the demutualization would have been able to express itself in a much stronger way. The example of the other cooperative banking groups, less structured in a democratic sense, goes moreover in this direction, as far as these last ones took years beforehand on the first one in appeal to the stock-exchange capital and, correspondingly according to us, some more billion euro of losses during the subprime mortgage crisis.

1.4 The scenario of radical demutualization

The conjunction of these three groups of symptoms lets us catch a glimpse of a scenario of radical demutualization: whereas the size and the maturity of banks tends to strengthen the asymmetries of power in favour of the central technocrats, the need to resort to private financing increases the pressure in return and burst Desroches' quadripartite institutional balance, which leads to a relative intensification of the emerging relation directors - shareholders of the highly-rated vehicles and so facilitates the technocratic centralism in a circle of auto-intensification of the imitation of the capitalist sector. At the same time, the flexibility offered by a formulation of *soft law* cooperative ethics allows to accompany this demutualization of a legal de-knitting which maintains only the appearances of a cooperative continuity, at least until the *de facto* demutualization became irreversible.

Is this scenario, which can seem extreme, all the most likely? Is it besides, on the same level, in the whole of the cooperative banking sector? A more detailed diagnosis, attentive to the movement of institutional reorganization as in its variability according to the places of power and the organizations, has to offer us some elements of answer.

2 The diagnosis

Many analyses have revealed that the *subprime* mortgage crisis was due to some extent to the search of far too brought up returns, imperative of profitability to which are subjected, to a lesser degree, banks recovering from a more "patient" finance (Jardat and Boned, 2008). Nevertheless, without reaching amounts observed at Société Générale and at BNP-Paribas, losses suffered by establishments endowed with a highly rated vehicle (Caisses d'Epargne-Banque populaire, Crédit Agricole) turned out to be disproportionate to establishments protected

from the shareholder pressure (Crédit coopératif), in spite of a size sometimes as big as that of the big capitalist banks (Credit Mutuel-CIC). This event reminds us that the cooperative banks do not form a homogeneous set but can recover, unlike a certain variety of statuses and culture which is not without consequences on their strengths and economic weaknesses. There is hardly to bet that their degree of "democracy" is also diverse. This report proves that there is on one side no cooperative purity and of the other one a capitalist radicalism which banks would be summoned to join, but an infinite possibility of gradations and possible choice in the evolution of the statuses and the practices of these banks. Where from, the interest to closely analyze their current processes of transformation, which may receive causes for concern for the perpetuity of the cooperative project but also the opportunities of renewal of its instruments in the service of this project, while questioning, via the law, the multiplicity which recovers the notion of democracy.

2.1 Economic Diagnosis

The economic prism allows to reveal the character of institutional balances dynamics which happen through the reorganization within cooperative banks. To foresee the situation, it is advisable to not only consider the cooperative institution, that is "a pre-existent and objectivable set of resources of justification at the economic agents' disposal anymore for their problems of coordination or their conflicts of reproduction" (Gianfaldoni, 2008: 8), such as the corpus of rights and statuses offer as example, the organization charts, the internal traditions. While observing, over time, emergent conventional constructions one can hope to identify the germs of a renewal of the cooperative project. Indeed, the convention results from interactions which occur between agents during tests of justification thrown, launched, relaunched or renewed (Bessy & Favereau, 2003). The notion of convention thus gets closer to that of 'bookmark' that Commons had created in opposition to that of the rule denoting a more motionless reality (Jardat, 2008b).

The emergence of such conventions was studied through the main coordination relations within the stakeholders of Desroches' quadrangle: the coordination between administrators and salaried directors, the coordination between members and administrators, the coordination between directors and employees and finally the coordination between employees and customers members. The board below synthesizes analyses redrawn in detail in (Gianfaldoni, 2008):

Coordination….	Facts / vivid observations	Emerging Conventions
Between administrators and salaried directors: national level	Diversity of statuses Common objective: growth and development	Economic utility conventions: Size effects Resources Economy Value added extension and market shares ->Expansion on regional territories
Between administrators and salaried directors: local level	Cooptation phenomenon of local administrators, legalised through elections Compromising on social objectives or on management, treatment of the files of the members-customers	Utility convention of economic and social value: Mutual understanding on the treatment of individual cases or appropriate to a given business sector - > Meshing of social networks
Between administrators and members	Weak influence of participative democracy on strategic questions Weak local cohesion strengthens the concentration of powers of national administrators	New conventions of economic and social utility: - Movement of non trade or non monetary incentives conform to the collective interest in monetary trade incentives - New non monetary incentives standing up from projects of general interest - > Project of social and local development, sponsorship, banking foundations
Between directors and employees	Movement from a '*fordist*' organization, stiff, based on qualifications with monetary and non monetary compensations to a weaker direct salary, through a wage system with individualized variable part, degradation of the operational routines, increase of the turnover	Conventions of skills, conventions of efforts, Contractual and organizational trust individual Preservation of tacit trust
Between employees and member-clients	Merchandizing of the services Depersonalization of the technical relation of the products	Conventions of competence at the economic and social intersection Cognitive Trust Acquaintance Experience Engagement of the members in social actions - > Legitimacy reinvested in the clientele relation

Such an analysis creates strong contrasts according to the establishment places of the agreements: most of the coordination relations, either only carry on economic utility conventions, or tend to separate the economic from the social in their

emergence, with on one side a pure logic of business and the other one a social counterpart divided within social actions or within sponsorship without consequences on the way of driving business. At the local level, the relation between administrators and salaried directors appears as the place of coordination that best seems to escape this dichotomy by the individual treatment of the files of the customer-members. From the point of view of democracy, it means that the most long-lasting anchor point of this last one in the cooperative banks is situated in this precise place that are the local boards of administrators cooperating with the local director. As the renewal will take it or not on the cooptation in the constitution of these councils, we can then qualify this hard core of democracy of cooperative banks of "Inhabitant of the Gironde"("Girondist") or "Thermidorien", even of almost "based on a tax qualification" in the case of a renewal till kingdom come of the same social group.

This double report, of a variety of statuses and of functioning on one hand, and the existence of a hard core precisely localized of this democracy on the other hand, leads to think that the democratic idea will find all the more concrete translation and will resist all the better to the demutualizing pressure than the group will be, by its statuses, decentralized in its functioning as in the distribution of the informative resources (information systems) and cognitive (training, qualification).

2.2 Organizational Diagnosis

If the cooperative banking groups have as a rule an inverse skeleton of that of the capitalist groups, they are some with regard to the others so diverse from the point of view of their organization and the group architecture as from the point of view of their rights and statuses. Statutory variety and organizational and management variety keep pace. So, the capitalist groups generally have a pyramidal structure, a parent company detaining the majority of the voting rights in subsidiaries which control their own subsidiaries, the system of the "waterfall of holding companies" being the extreme application of a company law which allows a minority shareholder (for example a family) to check de facto a multitude of companies. The cooperative banks are in an opposite situation: the local level detains generally the central structures, which supposes deliberations between local co-owners entities for all which concerns the central decisions engaging the common good of the cooperative group. Nevertheless this inverted "pyramid" cooperative does not present the same features in all the concerned banks. Whereas at the Crédit Agricole, the local entity owner is of a regional level, it is the Caisses themselves that, within the Crédit Mutuel, constitute the "basic cell" owner of the network.

This variability must be considered as a multiple source of information and crossed on the interaction democracy-organization. We suggest making a sketch by advancing three aspects of this interaction: 1 °) for a long time, the cooperative banking groups do not recover from a "pure" model; 2 °) certain group architectures may generate "distance reducers" between the democratic idea and its daily application and a “democratic strength” will result from it for the cooperative part which leads, in a certain way, to a "mutualisation" of the capitalist part and not to a demutualization of the cooperative party; 3 °) There were concrete cases where the performance and economic growth of a group kept pace with a deepening of the democracy.

2.2.1 The former "Impurity" of cooperative banking groups

With the constitution of hybrid cooperative groups detaining private law subsidiaries, we observe the concatenation, in their respective summits, of a cooperative inverted pyramid and a capitalist non-inverted pyramid to a mixed "hourglass", as it is illustrated with the example of the Crédit Mutuel (see fig. 1 below). Through the central entities, the members are certainly in command of the group. Nevertheless, situated in the bottleneck of the hourglass, the general management and the federative presidency federative directly control the capitalist part of the group. In the case of Crédit Mutuel the federative head plays a key-role in the relation customer-supplier (computing services in particular), which is established between this one and the customer Caisses.

The functioning that result from the observation reflects the permanent interaction between statutory peculiarities (law) and the organizational contents (the nature of the subsidiaries). At Crédit Agricole, the Press stated tensions between the requirements of profitability of highly rated vehicle (CASA) on one side and the concern of perpetuity and security of the administrators (employees in particular) stemming from the network of the other one. Within the Crédit Mutuel, a case study put forward a different dynamic. The base of the hourglass is here constituted with computing subsidiaries service providers for the Caisses of the network. The head of the network, responsible in front of Caisses, maintains the superiority of these last ones by ceaselessly asserting that they are customers of the subsidiaries and, as such, decide, as a last resort, of the relevance and the quality of the services supplied by these subsidiaries.

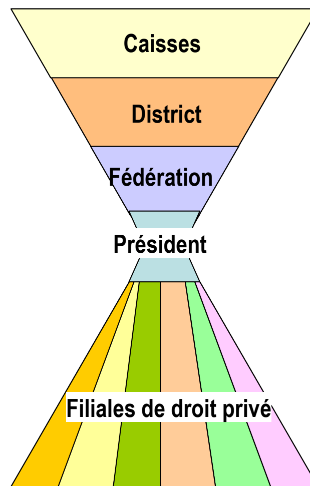

Fig. 1. The "hourglass" of Crédit Mutuel Centre Est Europe

2.2.2 Existence of "democratic distance reducers"

The interest of an institutional architecture where the basic cell (i.e. the Caisse) is of relatively reduced size lies in the nearness between the administrators on one side and the members of the other. The distance between elected decision-makers and voters is reduced, which guarantees a better representation, while making election for the council easier to cross than in big entities. Where from a certain renewal in the composition of the councils, which strengthens in return their representativeness and their legitimacy. *A contrario*, a weak ratio elected representatives/members, as well as a low rate of rotation of the elected administrators, can only tend to increase the distance between formal democracy and real democracy.

Another distance reducer, the training of elected representatives turns out to be a precious device to limit power appropriation by the salaried decision-makers to the detriment of the members. This technocratic drift was prematurely envisaged at Crédit Mutuel Centre Est Europe, by one of its historic presidents and the training of the elected representatives was explicitly asserted as a remedy: "the balance between knowledge and power can come true only if the elected representatives also have the knowledge" (Gueslin, 1982: 401-406).

Such an institutional architecture generates a specific shape of economic rationality: in an organization where the peripheral entities (federal) detain a strong power based on law, the central entities (federal) are in the obligation to work in service logic to the federal units. Logic of service all the more meaningful as, at least through law, the independent Caisses may put in competition the services returned by the federation with their own auto-performances, even with external providers. Thus, a Caisse commercialise products conceived by the marketing direction, not because it is obliged to do so, but because it considers them to be more relevant than the range of “house” products. The balance of power being so "inverted" compared to what takes place in a classic hierarchical company, any sorts of troubles of the capitalist bureaucratic company may be strongly limited: oversize projects and not adapted to the realities of ground, additional costs and inflation of staff and costs of the central services ("Parkinson law"), series of " stop and go " affecting change projects (in particular computing) insufficiently prepared in dialogue with ground operators whom they are going to affect, etc. (cf. Jardat, 2008). Indeed, in the case of a “hourglass” power architecture where the operational entities are at the top of power, the central services are in the real permanent obligation (and not only professed) to give satisfaction to the first ones, this obligation being ceaselessly reminded by the general management, hinge of the system (ibid)..

This economic rationality of a company’s democracy is measurable by its effects: for example, the unit costs of central services are widely lower in a federal mutualist bank than those whom we observe in a classic capitalist bank (Ibidem.). Thus, the democratic power conferred to local administrators does not uncork necessarily unto a mess of power and a decision-making inconstancy (clichés attached to democracy by aristocrats and oligarchs of all kinds since Classical antiquity), but on the contrary creates a balance of power, generative of relevant economic effects: the central entities are forced to abide by *low cost* structures supplying quality services to the local Caisses

Given that the subsidiaries of private law in charge of the functional services are in the service of the cooperative part, within which the federative functional entities are themselves in the service of the Caisses, the "contagion" of ways of functioning will tend to be made of the cooperative entity towards the capitalist entity and not the opposite. It is all the difference between the purchase and the creation of capitalist entities by a cooperative group and the partial sale of this cooperative group within a highly rated vehicle there. We can so define two ideals of the

hybridization between cooperation and capitalism. In the first case, the "hourglass" positions the democratic entity at the top of the institution and in fact the level vice-chancellor of the group. In the second case, it is the shareholders of the capitalist entity that may play this role and exercise a pressure in the demutualization (cf. figure 2)

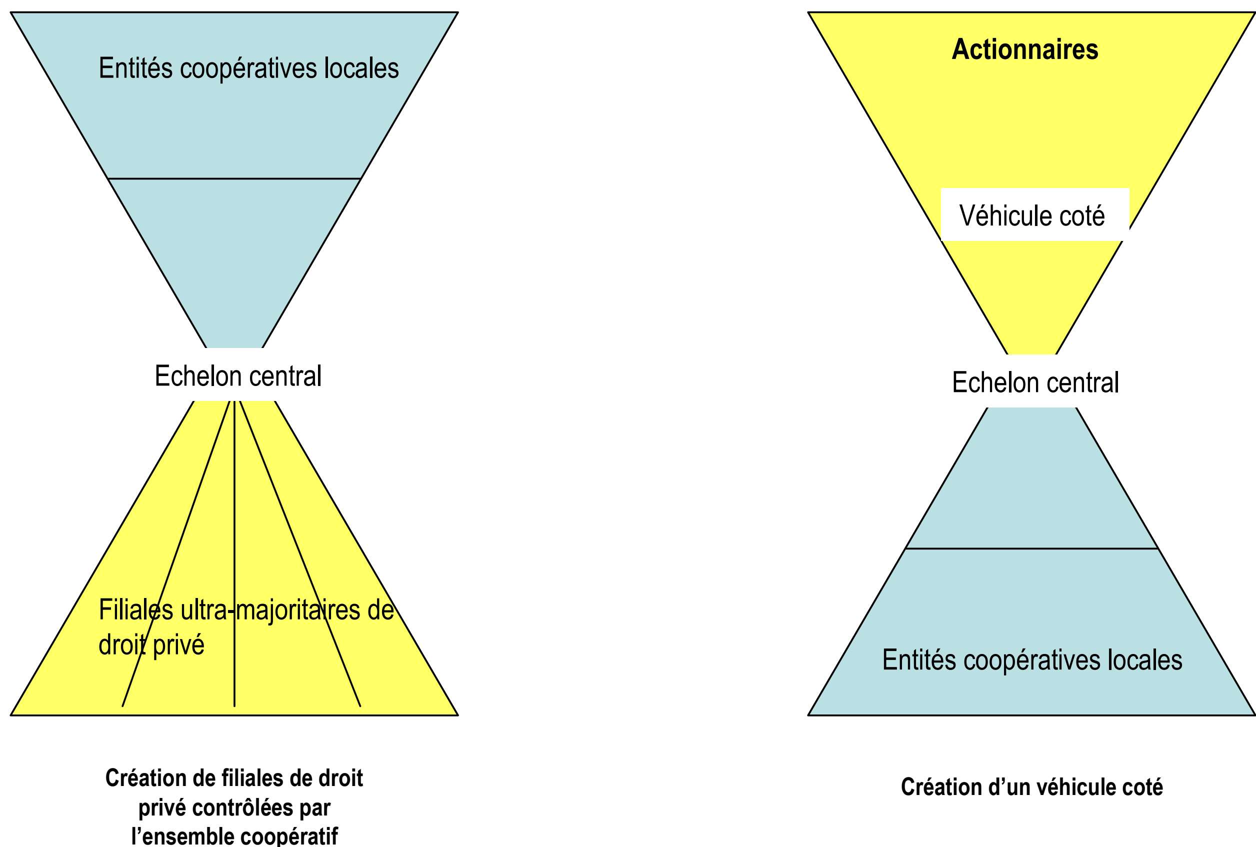

Fig. 2. The " reversal hourglass ": two ideals of the hybridization cooperation – capitalism

2.2.3 Democratic growth and evolution

Hybridization and growth are not paradoxical with cooperative democracy. This last one however cannot subsist without being transformed, as would tend to illustrate the history of the laws and statuses of Crédit Mutuel Fédération Centres Est Europe Europe (Gueslin, 1982; Jardat, 2008b; Jardat 2009). Indeed, built on the basis of a democratic cell of nearness, implanted in accordance with the " rustic Alsatian democracy " and Mosellanne, the Raiffaisen system underwent multiple evolutions during XX° century. *De-confessionalising*, political context fickleness and de-specialisation had put this model to the test, until 1960s, not without proving its robustness. The phase of strong growth of the years 1960-1970, carried in particular by the banking system of the lower and average classes, then by the invention of the bank insurance, constituted a factor of change of scale so considerable as the transformations in the course of the mutuality world. Nevertheless, we hardly assert, afterward, that the cooperative project subsided in that period.

We can only notice, at the same time, that this economic, technical and organizational evolution was accompanied, from the end of 1970s, by a major institutional evolution with the increase in power of a federal "parliament" and the drafting of a corpus of laws and statuses establishing explicitly the separation between an "executive power", a "legislative power" and a "judiciary power". The solidification of the federation thus came along with the elaboration of a kind of internal "constitution" to democratically settle the political functioning of an entity that has become too big to rest on the only geographical and relational nearness. The presented solution is one of mixture of representative democracy (importance of the Employers' federation as "parliament") and of plebiscitary democracy at multiple levels (local general assemblies, district and federal). It comes along at the same time with an effort of training of the elected administrators to the banking techniques, wanted by the developer of this constitution. This constitution was not drafted nor approved by a large majority in one day. It was the object of debates, long in their duration, and at the same time, wide in their participation and contradictory in their contents. That is why we can consider that through this constitution, it is a kind of *constituent power of the members* that expressed itself. The transpositions to the other banks

as to the social economic context, which is ours thirty years later, would not know how to be automatic nor without nuances. Nevertheless, two lessons of the history seem to be imperative:
1°) the impossibility to believe that a banking cooperative group can grow and develop its professions in a radical way and remain democratic, without its statuses evolving so as to offer new and adapted guarantees to this democracy to this new context,
2°) the fact that there are cases where hybridization between competitive necessities and cooperative project is not translated by the pure and simple everyday acceptance of the cooperative bank.

Legal Diagnosis

It is finally advisable to never forget the plural and evolutionary character of the notion of democracy, as demonstrated through its history, its theories and successive regimes. In particular, the cooperative world owes take into account this plurality and evolution capacities of the democratic possibilities as well as the necessity of a minimal coherence amongst the political, the social, the economic and the cultural so that this democracy does not remain a hollow formula or a rite deprived of emancipatory impact.

2.3.1 Plurality and evolution capacities of the democracy

Democracy is analyzed, at a minimal level, as a political system, in the same way as oligarchy or monarchy (Aristotle 2004). Democracy thus constitutes one of these fundamental questions of living together for which the jurist (as the political analyst) takes charge. It does not however present the rigorous terminological features terminological that usually characterize legal concepts. Its political dimension and the attraction which it produces since modernity has multiplied its usages and diversified its meanings. These senses are themselves extremely varied in the company but it is only by return about the politico-legal wealth of the notion that we can re-question the ambiguous relations between company and democracy.

During the course of history, democracy has pointed to various concrete modalities of organization of the political systems and, at the same time, to opposite connotations. We know that in antiquity, democracy characterized the Athenian city. Although it consisted of slaves, it had a scrupulous concern of not professionalizing political functions, using for example the drawing lots as the most neutral mode of appointment. It is also a model, almost mythical, of direct democracy. Very quickly nevertheless, the golden age goes out and democracy only comes back during the Renaissance with the interest renewed for the Greek culture and consistently its institutions. And so, democracy reappears as a positively appreciated political system and it will be finally established, following the revolutionary movement of the end of the XVIII° century, as the main model, considered even today, as impassable. The vote of the people appears in this concept as a central element, crystallising all attention, as it is shown through the struggle for the conquest of the universal suffrage. Nevertheless, behind this model, it is not certain that the agreement is so easy to realize on its precise contents, including within our western societies. And so, if it is not generally more forbidden to resort to a complete direct democracy, it remains in the imaginary as the only real democracy, the representatives in the indirect democracy always establishing a kind of treason of the represented. And this favour for direct democracy can be observed at every level of the collective life, mainly through the referendum. We saw the political stake on the occasion of the adoption of the European constitution treaty and the introduction of a referendum of local initiative by the constitutional law of March 28th, 2003 (art. 72-1 of the Constitution) is also a considerable demonstration. In the same way, the vote stopped representing the alpha and the omega of democracy, not being able to content itself with a periodic expression but requiring a continual participation, whatever the forms.

It is also the fundamental structures of our societies, which experience confusions, democracy tending to absorb all the central political concepts. It is there so of the separation of the powers and the state under the rule of law. Nevertheless, democracies have no privilege of the respect for these principles, as the significant number of monarchies still in place can attest; and the Human Rights Declaration of 1789 makes no reference to democracy whereas article 16 integrates the separation of the powers which classically refers to the requirement of a distinction between the legislative, executive and judicial powers (Montesquieu, 1998). Not only these are independent in the fact that they perform each a specific function for which they have exclusive competence but, besides, they can have mutual modes of control. Although these characteristics are not reserved for democracy, there is no doubt today that there is no democracy without their consecration.

The understanding that had *revolutionary France* however was not always shared and we can even say that it was finally given up. In 1789, there was such a eulogy of the people, taken as an entity, that all the partial elements, the diverse communities, were marginally dismissed or excluded. And thus, all the power was concentrated in the hands of the people's representatives. This led to the refusal of all the intermediate bodies or to the appointment of a guardian of the central political power, that movement traditionally represented by the Dallarde decree of 1791. America supplied another model (Tocqueville, 1999), established on the expression of institutionalized communities, about which we know the influence that it exercised. Thus, France gradually established the existence of labour syndicates (1884)

then association (1901), religious congregations (1905) and thus saw their place growing within the society. It is not only their number that must be notified here but the institutionalization of their capacity to represent distinct interests; general and particular interests, what the law calls collective interest. As such, associations and\or labour syndicates are, under certain conditions, more and more incorporated into structures of dialogue or decision for the elaboration of public policies, at every level and in all the domains. At the same time, jurisprudence gradually abandoned its reserve in front of the risk of dissolution of the notion of general interest and recognized their capacity to judicially represent these said collective interests (Dupont, 2008).

The same ambiguities can be seen as regards to the state of law, the notion conceptualized at the beginning of the XX° century (Herrera, 2003, p. 117). No more integrated into democracy than the separation of powers, it has nevertheless just as much part bound with it. The State of law consists mainly in the recognition and the guarantee of the fundamental rights, in other words the implementation of procedures likely to avoid the expression of arbitrary power.

This triptych gives a rather faithful image of contemporary democracy, that it is not congeal in marble and knows at present new evolutions. These are the fruit of a double theoretical reflection: on one side the procedural works of Habermas (Habermas, 1992), and on the other, the efforts to rethink the place of the citizen in an ultra – technical society (Callon Lascoume Barthe, 2001). From there, although in a deformed way, was born the development of participative democracy, through which, the political system tries to give to the citizens a more active and direct dimension in their participation in the political life. Without being able to speak about new shape of direct democracy, it is nevertheless certainly about a new phase of the democracy.

2.3.2 Consequences for the concrete translation of the democratic figure in cooperative companies

We see that the democratic figure is particularly rich and that its application to the world of the company can be carrier of numerous innovations. We could wonder about the legitimacy to integrate democracy into this particular place as far as the first one relies on political sphere whereas the second belongs to the economic domain. Two remarks however show a good part of the interest of the question, at least for this work. On one hand, democracy in the company became a classic question since the 80s, with the evolution of the conception of the company, the status has evolved from that of the business manager's property to that of an aggregate of persons and constitutive relations of homogeneous reality, then qualified as institution, within which democracy is the vector of the integration of its various members. On the other hand, the cooperative company, that holds here more particularly our attention, claimed for a long time its democratic character - the "one man, one vote" which presides over the organization of its general assemblies is symptomatically called democratic principle-, by making a distinctive criterion with regard to the said capitalist companies. In these conditions, it is the establishment of parallelism between the conception of democracy in political society and the cooperative company which must be looked for. But, in this search, one shall never lose sight of the wealth of the political notion. The only recognition of the capacity of all the co-workers to participate in the vote would not so know how to establish a sufficient indication of its democratic character.

A last remark must be made on this matter. Democracy is not a simple political shape at the risk of being only an empty shell. There is no democracy without the citizens' capacity to perform their part because to participate in the public life is not innate but results from apprenticeship. It can take extremely diverse forms but its result is indispensable: knowledge of institutions and their mechanisms, without which its functioning appears as an incompatible darkness that the citizen has to appropriate. Also, the citizen has to have a sufficient training to understand the life which surrounds it, without which he will not be capable of having an enlightened opinion on the questions with which his citizen's quality confronts him, and risks even to radically divert his interest from it. In brief, democracy is conceived only with citizens culturally ready for democracy, without which we are only in front of an enactment. It is obvious that this remark takes a particular strength as regards the cooperative companies, quite specially the banking cooperatives.

This necessity of the cultural adaptation arises today under at least a double dimension. On one side, the rights and statuses of cooperative groups owe to be in sync with the type of democratic request which emanates from the civil society to whom belong the members. The diverse collective phobias which build up around the problems of environment and health, as well as the procedures of participation of the citizens in the elaboration of big projects of general interest with strong impact on the lifestyles and the local residents (public meetings on the layouts of TGV (HST) and the other projects of infrastructure, for example) show that the civil society demands that the participative and technical constituents of the democracy develop. Cooperative companies could not henceforth make an impasse on these democratic dimensions in the evolution of their rights and statuses, at the risk of stopping being at the avant-garde of economic and social emancipation and seeing members turning away from the cooperative project to dedicate themselves to forms of collective action more in sync with the requirements of the civil

society. On the other hand, cooperative groups owe to raise a large number of members with the necessary capacities so that the participation is enlightened, which supposes an effort in technical training, but also strategic and sector-based information, either general, or targeted at a minimal level towards elected administrators, to co-decide daily with the salaried directors.

2.4 Synthesis

In the crossroads of the economic, organizational and legal diagnoses of democracy in French banking groups in transformation appear three key factors of perpetuity of a certain democratic reality:

1 °) Participation and technical democracy are necessary for the establishment of balanced conventions between the various stakeholders of the cooperative project. Where from, the required to train the actors (above all the members and the administrators) to avoid the technocratic confinement of the policy of these banks.

2 °) The nearness (physical but also institutional) appears as reducer of essential distance between the democratic idea and its translation in human behaviour. Where from, the interest of any authorities which, within the cooperative banking groups, move a small number of representatives closer to the members and the technical decision-makers. Some of these authorities already exist and have to remain without being emptied of their substance by parallel organs: they are for example the local boards of directors, the supervisory boards, the foundations. Other authorities are emergent or could be created which would imply the members in the life of a "technical and participative democracy" of the banking groups: thematic working groups, members' panels to judge the new offers of products services, etc.

3 °) The necessary evolution of the statuses can be only made downstream to the observation of a cooperative project renewed in acts because law is not creative in itself, only the project is. Where from a double necessity:

a) At first, a better knowledge of cooperatives by themselves (from a sociological, economic, organizational, legal point of view), so as to locate new modes of establishment of conventions reconciling imperative of performance, solidarity and democracy,

B) Secondly, a process of establishment of new statuses which reflects the constituent power of the member, by opposition to modifications made hastily, surreptitiously even.

3 Remedies

The establishment of a new cooperative project is indispensable in cooperative banks; we join here Daniel Coté's propositions. Without claiming to have sufficient data to have detected all the emergent forms of a new paradigm, we here intend to sketch what could constitute the main strength lines of the process susceptible to bring it to the foreground. The multidisciplinary crossing of our studies indeed brings us to formulate the following orientations:

A) It is required to show invention as statutory and as economic and organizational. The experiments made by Daniel Coté at the Caisses Desjardins agree with the observations made within the Crédit Mutuel: democracy, as constituent of the cooperative project, only exists if it is shown through within the daily practices of its stakeholders.

B) This invention would not however know how to limit itself to the only professional and managerial practices that imply, for the main part, only the employees and the customers members. So that the Desroches quadrangle continues to work in all its constituents, the cooperative reinvention has to rest on at least three pillars which appear on the crossroads of our analyses, with a certain order and without excluding round trips (figure 3):

I) Training
II) Comprehension
III) Constitution

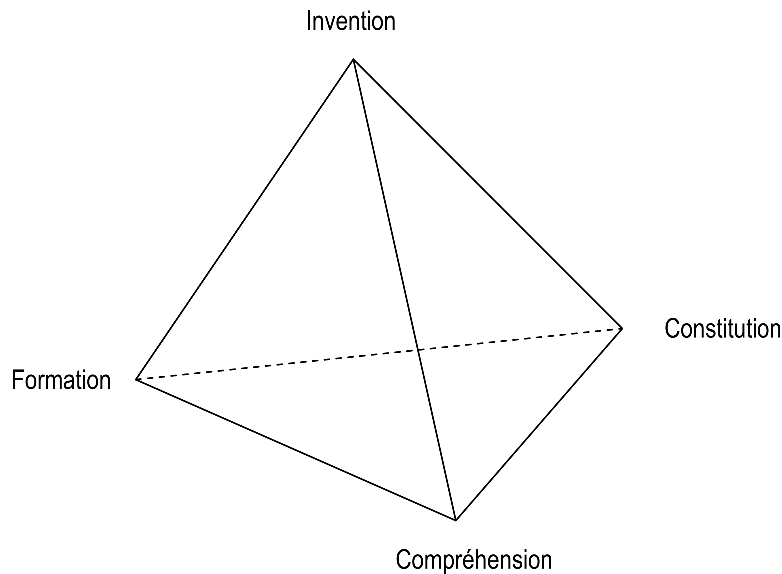

Fig. 3. The tetrahedron of cooperative reinvention: the invention rests on training, understanding and constitution

Training is indispensable to make the members and the administrators capable of exercising, with the necessary qualification, their constituent power. Without that necessary qualification, practices is mechanically applied a technical so narrow taxable rating as was it the financial taxable rating of the monarchy of July. Besides, it harbours two other virtuous effects: the first one is to strengthen the cohesion between members, because the sharing of technical and organizational mental plans is a form of institutional nearness. The second is to ceaselessly readjust the collective representation of the cooperative project, by a language that anchors in the bank environment as in its daily practices (commercial, technical etc.) as well as in its history.

The understanding that cooperative groups have of themselves is all the more indispensable to develop. The technical evolutions as institutional of their environment indeed bathe in a liberal ideology of "vice prosperity" widely orthogonal in their values. Inadvertently, the risk is then big to introduce organizational and managerial innovations, which result in a surreptitious demutualization. The cooperative banks have to develop a critical and lucid eye on the strengths and the weaknesses inherent to their statutory and cultural specificities, so as to enlighten the necessary evolutions of their functioning. The creation of institutes, the driving of community working groups (Pflimlin report) goes in this sense.

The constitution of new corpuses of laws and statuses should, as a rule, only intervene downstream to a sufficient development of the initiatives begun according to the two other pillars. It will be all the more fertile and justifiable, indeed, as will be associated with it the qualified and enlightened stakeholders. The scale of this constitutional challenge can be confronted to the duration, which was necessary, in the political history, for the fact that societies exceed the stage where, as Montesquieu had seen, only cities and microstates could work in republic, whereas the monarchic or despotic principle remained the lot of the big States. The elimination of illiteracy, the circulation of opinions by the print media, as well as the development of disciplines offering a bigger auto-reflection of the society (political economy, sociology) allowed to exceed the threshold of Montesquieu and to form big democracies. We can guess that this change of scale, for the cooperative company, will obtain a success of the same scale only if similar educational conditions and collective reflexivity are combined.

Conclusion

As the outcome of this somewhat programmatic panorama, we cannot miss to indicate, concerning the "understanding" part of the cooperative evolution process, the responsibility that befalls to researchers and teachers as to directors and the administrators who finance their works or to say the least who give them access to the data. The notion of pluralism has here another implication: the implementation of a new cooperative project will be collective, multidisciplinary, as it will combine members, managers, scientists and beneficiaries.

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IMPACT OF INDEPENDENT DIRECTORS AND REMUNERATION COMMITTEE ON FIRM PERFORMANCE? EVIDENCE FROM MALAYSIAN CAPITAL MARKET

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Abstract

This study aims at re-examining whether or not the structure of the corporate governance as defined by the non-executive director matter that lead to better performance. This study is based on 100 firms listed in first board. The analysis is based on a period of 5 years from 1999 through 2003. This study employs a multiple regression methods to examine governance structure and its impact on firm performance. Although previous studies in developed markets exhibit the existence of relations between governance structure and corporate performance, this study however concludes that there is partial relation between corporate governance structure and corporate performance. However, the presence of both audit and remuneration committee serves an important monitoring device to control management actives that lead to increase firm's performance.

Keywords: corporate governance, performance, non-executive independent directors, remuneration committee

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1. Introduction

The issue of corporate governance has been the focus of interest among academics, investment publics and policy makers due to its strategic implication for the firm's value, monitoring effect of management activities. The issue has gained popular attention in the recent years after the collapse of Enron, a giant utility firm and the collapse of World.com, a worldwide telecommunication giant in United State. Therefore, it is a question of interest to determine whether or corporate board structure and audit & remuneration committees are s instrumental in ensuring the interest of the shareholders are well protected.

So far there is no universally agreed definition on corporate governance that has been termed. And it is not a term of art too. Instead it is a form of self-regulation. It aims to ensure a process to be implemented within an organisation to direct the company affairs to be conducted with a view to enhance business prosperity and corporate accountability. Since directors are the custodian of the firms and are being elected by the owners to safeguard their very interest, there is ardent need to examine the corporate governance structure and any other forms that self regulate the management activities.

Malaysia introduced voluntary code of corporate governance in 2002. The companies listed on Bursa Malaysia are required to make public the statement of Corporate Governance incorporating disclosure on directors' remuneration. Under such code of conduct, listed companies are required formally to establish procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors and companies are advised to establish a remuneration committee consisting of wholly or mainly non-executive directors particularly after the collapses of Enron and World.com. This is to increase the transparency and disclosure requirements of annual report and management decision-making processes. Nonetheless, there are other who view for the case of Chinese own companies in Malaysia that Independent non-executive directors are appointed to the board according to the Chinese entrepreneur's own definition of independence (Low, 2003). These Independent Non-Executive Directors often sit on the board as a mere obligation to the entrepreneur, and for loyalty vote in the event of a countdown (Tong & Yong, 1998). As suggested in Tong andYong (1998), independent non-Executive directors are not truly independent in Chinese controlled companies in Malaysia, therefore, they cannot be expected to carry out the monitoring function effectively. Thus, their presence on the board is unlikely to improve financial performance of the company. This is especially so in Malaysia when annual general meetings are usually poorly attended, and resolutions are passed with hardly any debate (Low, Yong & Shanmugam, 2004).

The existing literature on the importance of board composition and its structure on firm performance has been limited both developed and developing economies. The pioneered in such issue has been addressed by, Jensen (1993) argues that small boards are more effective in monitoring a CEO's actions, as large boards have a greater emphasis on ''politeness and courtesy'' and are therefore easier for the CEO to control. Yermack (1996) finds an inverse relation between board size and Tobin's q in a sample of industrial companies, and concludes that large boards are less effective than small ones. However, in Malaysia so far no systematic evidence on this issue is well documented. Therefore, this paper aims at identifying relationship between the Corporate Governance structure and the corporate performance**.** The paper is organized as followed. Section two present the evidence on corporate governance and section three briefly describes the methodology used to examine the said relationship. The findings and conclusions are presented in section four and five respectively.

2. Review of the literature

Recent development in the theory of the firm emphasizes the importance of monitoring management activities. A good corporate governance structure may resolve agency problem issues surface in the firm level. Jensen and Meckling (1976) argue that there is an inherent agency conflict exists between owners and managers because of divergence of interest and utility maximization. One way to mitigate this problem is to have independent non-executive directors to provide objective judgement about firms performance and oversee the management activities, while having independent remuneration committee may also give oversight about remuneration for executives. There is a great of literature on the director composition and likely impact on firm performance. For example recent empirical papers have examined the idea that the ideal board structure may vary with firm characteristics. Denis and Sarin (1999), Gillan, and Starks (2000), Gillan et. al (2003), Lehn, Patro and Zhao (2003), and Boone, Field, Karpoff and Raheja (2004), among others, have found crosssectional differences on board size and composition.

A number of studies have also linked the proportion of outside directors to financial performance and shareholder wealth (Brickley et al., 1994; Bryd and Hickman, 1992; Subrahmanyan et al., 1997; Rosenstein and Wyatt, 1990). These studies observed a better stock returns and operating performance when outside directors hold a significant percentage of board seats. But overall, existing evidence has yielded mixed results about the types of board characteristics that facilitate effective monitoring and improved governance (see surveys by John and Senbet (1998) and Hermalin and Weisbach (2003)). Furthermore, very little theory has emerged to provide insights into the effects of different board structures on firm value (Charu, 2005).

While Conyon (1997) examines the influence of remuneration committee adoption in UK companies as a monitoring substitute, and finds that, in some circumstances, the adoption lowers the growth rates in top director compensation. Conyon and Peck (1998) investigate the affect of outside directors in remuneration committee decisions, and report that they enhance the pay-for-performance sensitivity. However, studies in the US by Anderson and Bizjak (2003) and Vafeas (2003) report insignificant results on the influence of remuneration committee independence towards level of CEO pay. A more recent study by Sun and Cahan (2009) attempts to provide explanation for the mixed findings. Using a broader and richer measure of remuneration committee quality instead of just focusing on independence, they show that the sensitivity of CEO compensation to accounting performance is related to the governance quality of the remuneration committee, for US companies with fully independent remuneration committees.

To further search on the board structure, Benjamin and and Weisbach (1991) examined the effects of board composition and director incentives in public utility firms' performance and find that compensation packages for senior managers somehow have impact on firm performance. In a related study, Catherine Dail and Dalton (1992) focused specifically on the role of founder chief executive officers and the composition of boards of directors on corporate performance. They found some support for the ability of founder and non-founder CEOs to relinquish the tight control and effectively guide the growth of the firms. They further suggested that there are strong linkages between the CEO and directors and firm performance among the largest firms. Furthermore, the evidence also suggest that even strongest linkages are evidenced in the more modestly sized firms.

Anup and Charles (1996) examined seven mechanisms to control agency problems between managers and shareholders. These are shareholdings of insiders, institutions, and large block shareholders, use of outside directors, debt policy, the managerial labour market and the market for corporate control. The findings show a significant relationship between firm performance and four of the mechanisms stated above when each is included in a separate OLS regression. James and Morra (1997) has reviewed the book of "Corporate Decision Making in Canada and concluded that there is no existence of relationship between corporate governance and corporate performance. Similar study was also further searched by Ned Regan (1998) and examined the relationship between the board governance and corporate performance. However, no significant relationship was observed between the corporate governance and corporate performance.

Further search on issue was again documented by Scott and Rosenstein (1998). They examined the relationship between board composition, managerial ownership and firm performance. The results indicate some support for the curvilinear relationship between managerial ownership and performance posited by Stulz (1988) and empirical research of Morck, Shleifer and Vishny (1989) and McConnell and Servaes (1990).

David and Wier (1999) has analysed the extent of Cadbury compliance of corporate governance and its impact on corporate performance in UK firms. The study evidenced that the duality is less common while firms tend to have more than 3 non executive directors and there has been an almost universal adoption of board subcommittees such as the remuneration and audit committee.

Data and Methodology

A sample of 100 firms most of which are drawn from CI component firms, serve as market barometer over the period 1997 through 2001. The proxy for board structure is derived from number of non-executive director to total directors governance and firms performance are extracted from companies annual handbook, companies annual reports and many other sources. The choice of period is of significant for two reasons. Firstly Malaysia economy recovered from worst financial crisis in 1999. Secondly after the Asian Financial Crisis Malaysia adopted code of conduct on corporate governance on March 2000.

Operational Model

$$Yit = \beta_0+\beta_1 NEDit)+ +\beta_5(COMit)+\beta_6(MKTCPit) + \varepsilon$$

Where

- Yit – this is corporate performance proxied by level of net income before tax divided firm's total asset at period t.
- *Indirec* – This is the binary variable which has a value of one if independent non executive directors represent at least 50 per cent of the board and zero for otherwise.. It expects organisations with more than 50 per cent of independent non executive directors would have better monitoring system.
- *Committees* – This refers to the presence of audit and remuneration committee. It is a binary variable taking a value of one if a company has both committees and zero for otherwise. It is believed that there is positive relationship between the presence of committee and performance
- *Size* – This is measured by market capitalisation and is used as a control measure to analyse the extent of size effects present in the governance structure.

Findings: Table One

* , **,*** significant at 10%, 5% and 1% level respectively. Durbin Watson 2.0162. F-value 2.9842 (P=.0234)

Variable\t-value	1997	1998	1999	2000	2001	Average t-value
Indirect	1.59*	-0.197	-3.541***	-1.19	0.641	-0.5394
Com	2.056**	2.609***	2.014**	1.236	0.635	1.71*
MKTCP	1.914**	1.13	2.725***	2.842***	2.677***	2.2576***
R-Square	0.171	0.158	0.219	0.12	0.131	0.1598

Table-1 shows the findings from the annual regression over a period from 1997 to 2001. However, to examine over all effect of board structure on corporate performance, the significant of the t-value are averaged up over the 5 years period. To isolate the size effect on corporate performance, a control variable is included into the model which is proxied by the market capitalization of the respective firm. The findings appears to suggest that the presences of both audit and remuneration committees as proxied for corporate governance structure does play an important roles for the firms performance for the period 1997 to 1999 (economics downturn). However, the dominance of independent non-executive directors provides no apparent explanation for firm performance, except in year 1997. Surprisingly, finding of a negative and significant relationship between independent non-executive directors and firm performance for year 1999 is rather astonishing. This could be due to the fact that listed firms particularly after financial crisis tend to have more of non-executive directors as part of the board structure to window Dress Company's outlook. Thus, corporate governance structure can explain partially explain for the performance of the firms. The percentage of independent non-executive directors is not found to have any significant impact on firm performance. The average R-square of 15.8% suggest that changes in corporate performance is partially explained by selected corporate governance variables included into the model. The model is significant at 5% level with the f-value of 2.948.

Conclusion

Corporate Governance is widely accepted worldwide since the publication of Cadbury Report in 1992 in UK. However, it has been adopted by the London Stock Exchange in 1995 and Kuala Lumpur Stock Exchange in only 2000. As the analysis period consists of 5 years from 1997 to 2001, this is not intended to examine the compliance effect of such

code of conduct in this paper. Although previous studies in developed market exhibits the existence of relations between governance structure and corporate performance, this study however concludes that there is partial relation between corporate governance structure and corporate performance over the period 1997 to 2001. While the presence of independent non-executive directors does not have any significant impact on firms performance except for the year 1997 and 1999. However, the firm size appears to have significant impact on corporate performance.

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SHAREHOLDER BASE MANAGEMENT IN COMPANIES IN THE NEW MARKET LISTING SEGMENT OF THE BOVESPA STOCK MARKET

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Abstract

The study analyzes the characteristics of the investor relations departments at Brazilian listed companies in the New Market listing segment of the Bovespa stock market and their shareholder base management practices. Data were collected through questionnaires sent to 100 companies in this segment in June, 2008, 21 of whom responded. The results show that most companies are still managing their shareholders base inefficiently and making inconsistent use of performance indicators. The study also revealed that there are few options of technological IR tools on the market to help IR departments to obtain the potential benefits of shareholders base.

Keywords: stock market, Brazil, market listing

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1. Introduction

Brazil has witnessed an exponential growth of investor relations (IR) activities, especially during and after the wave of companies going public in the years from 2004 to 2007. Following the regulamentation of the segments of corporate governance, Brazilian governmental and publicly traded institutions, such as the Brazilian Securities and Exchange Commission (CVM) and the São Paulo stock market (Bovespa), presently demand that all companies appoint an IR manager to handle information requests from present and former shareholders, potential investors, specialized Press agencies, analysts, regulatory agencies and other stakeholders.

The IR director is a key player in the company/market relationship and is responsible for providing the market with information on company performance and for informing company administrators of the investors' and analysts' perception of the company's performance.

The activities of IR professionals include meeting the demands of shareholders and capital market regulations and preparing and managing communication between the company and the market. When dealing with shareholders, knowledge of the company's shareholder base is essential to design strategies for each target group and thereby increase liquidity and company value.

The present study is an analysis of the IR and shareholder base management of Brazilian public companies in the New Market listing segment of the BOVESPA stock market. The specific objective was to identify the shareholder base management tools used by the companies, the major difficulties and benefits encountered in IR management and the use, if any, of indicators to evaluate shareholder base management performance.

Following this introduction, Section 2 provides an overview of IR and shareholder base management; Section 3 describes the methodology employed in the study; Section 4 includes compilations of colleted data and a discussion of our findings; Finally, Section 5 summarizes our conclusions.

2. Investor relations

IR activities gained momentum early in Europe and the US where capital markets were already developed and companies were soon hiring professionals specialized in writing reports on financial and operational results and in meeting investors' demands (Marston, 2008). A relatively novel activity in Brazil, IR management only truly picked up in the nineties and boomed in the period 2004-2007 when a large number of Brazilian enterprises opened their capital.

According to Agarwal and coworkers (2008), IR activities have grown significantly over the last decades in response to stakeholders' demand for

transparent financial information. Allen (2002) associates the great leap of importance in IR management with the aftermath of the Enron scandal, as stakeholders started demanding greater transparency and information quality and IR professionals found themselves facing the challenge of rehabilitating the confidence of investors.

Costa (2001) claims that for companies desiring to remain competitive on the market it is indispensable to establish a department of investor relations increasing company visibility and contributing to the company's image on the financial market. Presently, enterprises transitioning to open capital regime already employ IR professionals in the building of a solid relationship with the market.

The National Investor Relations Institute (2007), a US-based institution for IR professionals, defines IR management as:

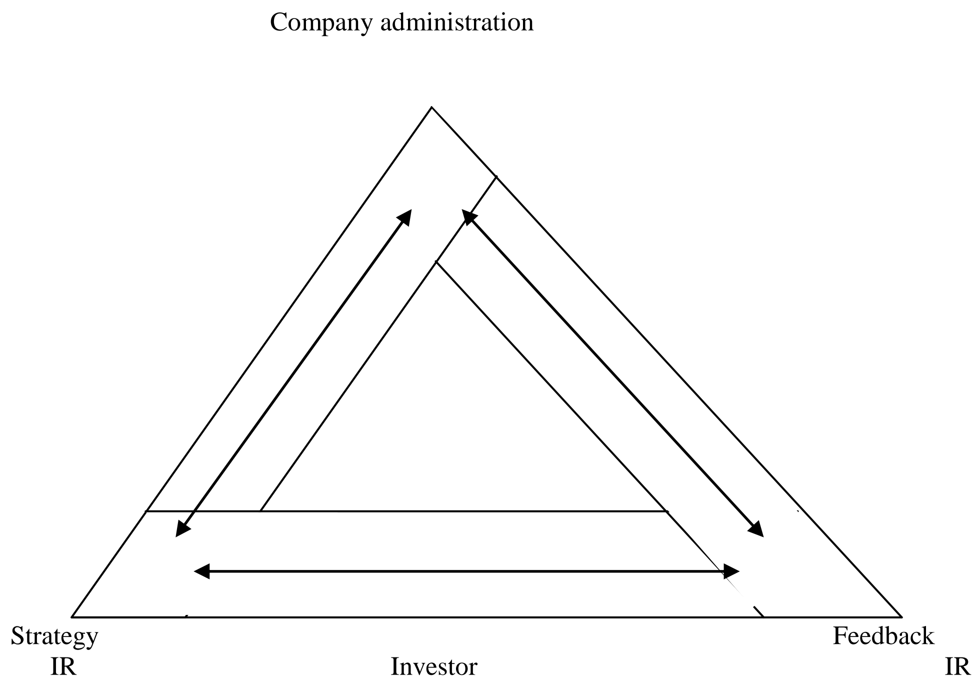
"[...] a strategic management responsibility that integrates finance, communication, marketing and securities law compliance to enable the most effective two-way communication between a company, the financial community, and other constituencies, which ultimately contributes to a company's securities achieving fair valuation."

According to the Brazilian Investor Relations Institute (IBRI) and the Bovespa stock market (2007, p. 11), IR professionals play a strategic role in the company as they are responsible for communicating internal information to external constituencies and for bringing feedback to the company administrators thereby improving internal practices and satisfying market demands. This view is expressed by Higgins (2000, p.26) who believes that IR professionals should participate actively in high-level administration since they are aware of the market's evaluation of the company's performance and can ensure information regarding strategic activities reaches the financial community.

Mahoney (2007, p. 45) found IR management to be directly associated with the value of the company. IR professionals are expected to inform company administrators regularly of how the market evaluates the company's performance so company strategies may be aligned with the context of value generation.

To do a good job, IR professionals need ample access to fresh and precise information, whether it be on macroeconomics, the targeted market segment or the company itself. According to Higgins (2000, p. 76), the information flow between the company and the market should basically follow a triangle pattern; that is, information should travel from the high-level administration through the IR manager to the investors, and back the same way (Figure 1).

Company administration



Strategy
IR

Investor

Feedback
IR

Figure 1. Investor relations triangle
Source: Adapted from Higgins (2000, p.78)

According to IBRI and Bovespa (2007, p.35), the main objectives of an IR program is to provide quality information to analysts and investors, to expand the shareholder base, to identify investors matching the company profile, to ensure company information represents the actual value of the company and to give high-level administrators qualified feedback from the market.

An efficient IR program, says Higgins (2000, p. 70), should reflect the 4 C's of investor relations: *compliance* to norms and requirements of disclosure, *credibility* with the entire financial community and

the internal administration, *commitment* to company management policies and *consistency* between company actions and what is communicated to the market.

The daily work of an IR professional includes the writing of documents to meet the regulations of the capital market, direct contacts with domestic and foreign shareholders, the building of relationships with buy-side analysts (who evaluate companies and effect the purchase and sale of shares) and sell-side analysts (who publish company evaluation reports) and the development and updating of a range of communication tools, such as IR websites, financial results conference calls, individual meetings and public presentations of results.

To carry out these tasks, IR professionals must interact with several different company divisions and develop good interpersonal relationships, both internally and externally with the market.

Bushee and Miller (2007) believe that interactions with buy-side analysts are crucial to the long-term success of any IR program. However, other factors play an important role, such as the coverage of analysts and the media which, if properly done, does much to increase the visibility of the company. In fact, all activities aiding IR professionals in their efforts at achieving and maintaining fair valuation should be considered essential to the development of a successful IR program.

IBRI and Bovespa (2007, p. 37) recommend the adoption of IR indicators to evaluate the relationship between the company and its investors, measuring the evolution in the number of analysts monitoring the company, the number of public meetings, the number of individual meetings and interactions with investors, share volatility and liquidity as well as the size and, if applicable, the composition of the shareholder base.

In addition to the indicators above, Mahoney (2007, p. 371) observes that IR management performance should also be evaluated by the quality of the information provided at meetings, in published reports and on the company website.

The evolution of volatility, liquidity and shareholder base size can be significantly promoted by proper shareholder base management. A study by Merton (1987) shows that falling demand curves for shares of companies with small shareholder bases indicate a smaller market value even when good results are expected. Likewise, Amihud and colleagues (1999) found that the appreciation of shares in Japanese enterprises was positively correlated with the size of the shareholder base. Thus, efficient shareholder base management may serve as a means to attain satisfactory levels of indicators.

2.1. Shareholder base management

Managing the shareholder base involves monitoring the entry and exit of shareholders in order to develop relational strategies capable of attracting and/or maintaining interest in the company's shares as an investment opportunity on the capital market. It helps the company identify the profile of its shareholders and provides the information required for the planning of communications with present and former shareholders and potential investors. The activity is usually carried out by IR professionals in the company who are in direct and continual contact with the market.

Shareholder monitoring begins when the IR manager receives the consolidated shareholder base position from the company's custody agent. IR professionals can use this information as they please, dealing with shareholders individually or grouping funds administered by the same company. Some companies organize the information in spreadsheets while others manage their shareholder base with commercially available or self-developed software.

A range of useful technological tools are available for shareholder base management. Domestic and foreign software products make it possible to view the history of shareholder entries and exits, new investors and the largest purchases and sales over a given period. Some of these tools can group shareholders in different ways so IR managers can view entries and exits individually or as companies managing multiple assets.

According to IBRI (2008, p. 112), the adoption of technological IR management tools is necessary to deal with work demands and respond to inquiries. At present, the most widely used systems are Customer Relationship Management (CRM) and Extensible Business Reporting Language (XBRL).

The adoption of a CRM system allows to integrate people, processes and technologies to the benefit of the company's investor relations (IBRI, 2008, p. 112) and to identify specific interest groups for the improvement of communications and services.

Companies using technological tools can better keep track of investor entries and exits and variations in the holdings of each shareholder so as to focus communication on selected shareholders and prepare to act when an important potential investor appears (Mahoney, 2007, p.78). Monitoring is essential when the company objective is to change the composition of the shareholder base through the inclusion of foreign or domestic investors or natural persons.

In order to change the composition of the company's shareholder base, the IR professional must determine a profile of shareholders on which to base strategies and identify former shareholders and potential investors. Then investors are contacted and informed about the company, its results and strategic perspectives. New entries in the shareholder base are monitored with the consequent changes in shareholder base composition.

IR professionals have access to the information required to revert previous exits of shareholders if such shareholders should match the desired investor profile.

Shareholder base management also helps identifying potential investors by discovering assets, asset management companies and banks, among others, whose profile matches that of the present shareholders. This process is referred to as targeting and was defined by Treiger (2009, p.33) as a set of measures designed to identify and attract desirable, long-term investors to the company.

Changes in shareholder base composition may be measured by the number of new entries in the base, variations in the proportion of domestic to foreign investors and the inclusion of new investment clubs and natural persons (Mahoney, 2007).

Mahoney (2007) adds that it can be risky or undesirable to concentrate shares in the possession of a handful of shareholders who might at any moment sell *en bloc* and cause prices to plummet. To prevent this, companies may wish to increase the number of retail investors. This will not only create a larger spread in the shareholder base but will increase share liquidity through greater trading volumes.

A greater number of investors can also boost company performance. A study by Frieder and coworkers (2008) found a correlation between the increase in the number of non-institutionalized shareholders and the increase in sales, especially in companies of the retail sector. According to the authors, potential investors are also potential consumers, and those who become shareholders will follow the company at closer range and learn more about its products.

In the opinion of Treiger (2009, p. 50), shareholder base management can also help prevent unforeseen events in the company, such as loss of control of a given shareholder due to the trading of others, the unexpected appointment or election of board members contrary to the preferences of the company and the establishment of fiscal councils.

Thus, to avoid predicaments and ensure the implementation of shareholder management strategies the company is advised to have an IR professional monitoring and managing the shareholder base.

Shareholder base management performance can be evaluated through the identification of a shareholder profile, the monitoring of major transactions and shareholder interactions and the use of indicators reflecting the evolution of share prices, liquidity and shareholder base composition. Depending on the company's strategic objectives, the above criteria may be weighted differently allowing the IR team to align their actions with corporate policies.

3. Methodology

The present study was exploratory. In order to analyze the characteristics of the department of investor relations and the shareholder base management of companies in the New Market listing segment of the BOVESPA stock market, data from 100 companies were collected with previously tested questionnaires in mid-2008. The respective IR professionals were contacted directly by e-mail and telephone during a period of approximately 20 days. In general, the interviewees cooperated enthusiastically and were persuaded the study would contribute to the development of their activities.

The questionnaire, which included 20 open-ended and multiple-choice questions, was divided into two main sections: On one hand, company profile and IR management; on the other, shareholder base management. The first section was designed to collect information on the company structure and on the department of investor relations: how it works, how long it has been in existence and the main practices employed when dealing with the market. The second section was designed to verify if and how companies are managing their shareholder base.

Two categories of analysis were established: 1) IR activities and 2) Shareholder base management. Based on the theoretical references of the study, specific aspects identifying these two categories, along with their associated variables, were used to prepare the tables on which our analysis is based.

Twenty-one of the 100 companies contacted for the study completed the questionnaire. Figure 2 shows the distribution of responding companies according to sector. Thus, sampling was non-probabilistic by accessibility.

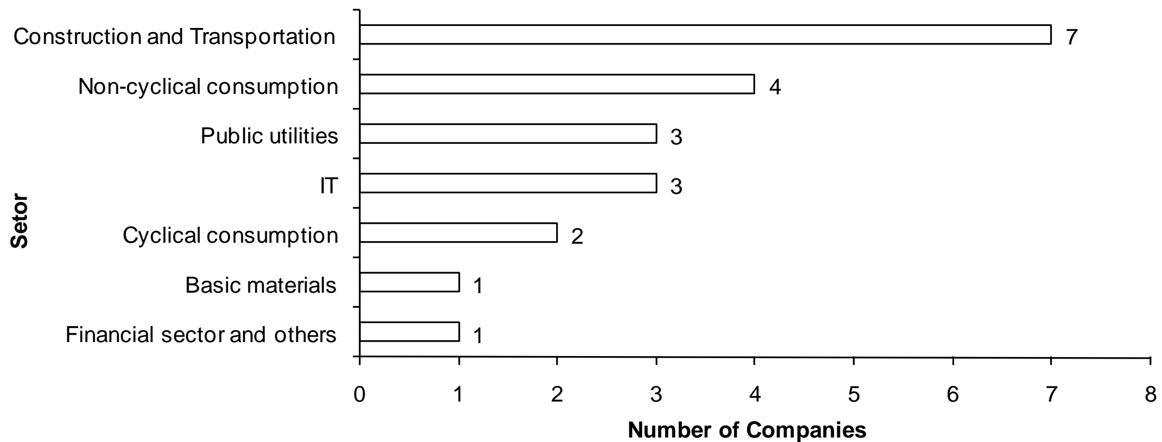


Figure 2. Responding companies according to sector.

Source: The authors.

4. Analysis and discussion of results

4.1. IR activities at responding companies

On June 30, 2008, questionnaires were sent to the 100 enterprises comprising the New Market listing segment of the BOVESPA stock market (segment with the highest level of corporate governance). Most of the responding companies had a net annual revenue between BRL 500 million and BRL 5 billion. In order of frequency, the 2007 net revenue of the 21 responding companies (Table 1) was BRL 1–5 billion (n=9), less than BRL 500 million (n=8), BRL 0.5–1 billion (n=2), BRL 5–10 billion (n=1) and more than BRL 10 billion (n=1).

Table 1. Profile of responding companies

Characteristics	Variables	Number of Companies
	Million BRL	N=21
Net Revenue in 2007	over 10,000	1
	5,000 - 10,000	1
	1,000 - 5,000	9
	500 - 1,000	2
	Under 500	8
Time since IPO	Under 1 year	1
	1 - 2 years	7
	2 - 4 years	9
	Over 4 years	4

Source: The authors.

With regard to the time of initial public offering (IPO), only one of the responding companies had become a publicly-traded enterprise within the previous year (August 2007–August 2008). Seven companies had been public for 1–2 years (August 2006–August 2008), nine had been public for 2–4 years (August 2004–August 2008) while four had made their IPO over 4 years earlier. Since few of the sampled companies had long-time experience with public trading or shareholder demands, the work of the IR professionals—as companies were migrating from organizational structure to open capital—was particularly complex.

Our findings confirmed the perception that IR activities have grown considerably in Brazil over the past few years, as expressed not only in the growing number of IR professionals but also in the role IR management has come to play in the company structure. Table 2 shows that all the responding companies informed having a division exclusively committed to IR activities. The same trend was observed in a study published by IBRI and Fipecafi in 2006 in which 96% of the sampled companies already possessed a department committed exclusively to investor relations.

Table 2. IR profile of the 21 companies included in the analysis

Characteristics	Variables	Number of Companies N=21
Exclusive IR Department	Yes	21
	No	0
Time of existence of formal IR Department	Under 1 year	1
	1 - 2 years	7
	2 - 4 years	9
	Over 4 years	4
Number of staff in IR Department	Up to 2	3
	3 - 5 staff	16
	Over 5	2

Source: The authors.

In the sampled companies, the establishment of a department of investor relations coincided with the time of IPO (Table 2). Thus, the companies migrating to open capital structure over the past few years have demonstrated a clear understanding of the role of IR activities in their communication with the market.

Our study reveals that, compared to other company departments (such as sales or accounting), departments of investor relations are staffed by a relatively small number of professionals. Thus, in spite of the need to communicate with multiple departments to produce the information required for their daily activities, Brazilian IR departments typically function with a very limited number of staff. Fifteen of the 21 enterprises included in the study employed 3–5 IR professionals while three companies made with only two. Only two companies informed having over five staff in their departments of investor relations.

The number of professionals employed in the department of investor relations was found to be directly related to the size of the enterprise. Accordingly, the two companies with over five IR professionals on the payroll reported net revenues over BRL 5 billion in 2007.

IR managers have to deal with a range of different professionals and institutions to meet the company’s demands. The sampled companies focused their daily IR activities on various target groups. Thus, twelve companies were particularly committed to foreign investors, 10 to natural persons, 12 to sell-side or buy-side analysts and 11 to portfolio managers. The remaining 9 companies claimed not to focus on any specific target group but to adjust to demands on a daily basis as they emerge from different groups.

Table 3. Target groups and IR communication tools

Characteristics	Variables	Number of Companies N=21
Target group	Foreign investors	12
	Natural persons	10
	Sell Side Analyst	12
	Buy Side Analysts	12
	Portfolio Managers	11
	None	4
Communication tools	Mailing	20
	Conference Calls	21
	Individual meetings	21
	International conferences	20
	National conferences	20
	Conference Calls	19
	Non Deal Road Show	19
	APIMEC-sponsored events	19
	Site Visit	16
	Others	3

Source: The authors.

Different target groups require the use of different communication tools. As shown in Table 3, the most commonly used tools are conference calls and individual meetings, followed by conferences sponsored by domestic and foreign investment banks. Results conference calls, non-deal road shows

(organized by the top-level company administration to meet with shareholders and/or potential investors) and events held by the Association of Capital Market and Investment Professionals (APIMEC) were mentioned by 19 of the companies in our sample. Site visits to commercial or industrial facilities were reported by 16 enterprises.

Finally, 3 companies reported using other forms of communication with the shareholders, such as chats, IR websites and Investors' Day arrangements (gathering potential investors to visit the company, meet executives and learn about investment opportunities). Companies also kept their IR websites up-to-date with real-time information offering shareholders interaction with greater transparency.

4.2. Shareholder base management

Initially IR professionals of the responding companies were asked about their every-day shareholder base management practices. Our findings show that companies were concerned with the effect of the entry and exit of shareholders upon share prices and liquidity. As shown in Table 4, twenty companies reported practicing some form of shareholder base management. In a single company, the shareholder base was not managed as it had not been included among the priorities of the department of investor relations.

Table 4. Shareholder base management

Characteristics	Variables	Number of Companies N=21
Management of shareholders base	Yes	20
	No	0
	Expected to start within 12 months	1
Use of software to manage shareholders base	Yes	6
	No	11
	Expected to start within 12 months	3

Source: The authors.

Only six companies used some type of software to manage their shareholder base. Eleven companies stated they did not possess such software, while three informed they intended to purchase software within the next twelve months. Since the Brazilian market offers few options of software for shareholder base management, some companies have developed their own technological tools tailored to their specific needs.

The size of the company was not a determining factor for the purchase of shareholder base management tools. The six companies managing their shareholder base with software reported revenues under BRL 5 billion—in fact, half the companies billed less than BRL 1 billion in 2007.

Companies without software to manage their shareholder base generally used spreadsheets filled out with information received from their custody agent. On a regular basis reports were issued with lists of the major shareholders or the main entries and exits over a given period.

In companies employing technological tools shareholders were monitored daily and entries and exits were registered individually or grouped according to asset management company for later contact and identification of the reason for the purchase or sale of shares.

As shown in Table 5, the participating companies had a generally favorable opinion of the use of software for shareholder base management. Three companies were very satisfied with the adopted software, two companies were satisfied and one was indifferent.

Table 5. Use of technological tools for shareholder base management.

Characteristics	Variables	Number of Companies N=6
Satisfaction with software	Very satisfied	3
	Satisfied	2
	Indifferent	1
	Dissatisfied	0
	Strongly dissatisfied	0
Obtacles to purchase softwares	Cost	2
	Few option on the market	4
	Complex operation	1
	Incompatible with the company structure	0
	Little practical utility	1
	Incompatible with company needs	0
	Others	2

Source: The authors.

However, difficulties with the acquisition of technological tools for shareholder base management were also identified. The main complaint—expressed by 4 companies—regards the lack of software options on the market. Indeed, since IR management is a relatively recent practice in Brazil, few technological tools are available on the market. With software development at an early stage, current software products have generally been adapted to IR management from existing customer relationship management tools. The literature describes other specialized software products available on the international market, but these tools have been found not to be in accordance with the reality of Brazilian companies or even the Brazilian capital market.

Other problems related to shareholder base management software included the cost of acquisition and/or maintenance (n=2), complicated operation (n=1), little practical utility (n=1) or the difficulty of acquiring software products in the form of modules. Some software products feature shareholder base management tools bundled with several other applications. Since developers do not offer modules separately, companies have no choice but to purchase a package of software containing applications for which they have no use.

Our findings show that the use of technological tools for shareholder base management does not dispense with the need for IR professionals. Thus, the three companies in our sample employing fewer than three IR professionals did not use any specific software, while all departments of investor relations operating with shareholder base management software were staffed with 3–5 employees.

Companies managing their shareholder base with or without software tools reported both benefits and difficulties in their task. The main benefits include the possibility of monitoring purchases and sales of shares and of targeting potential investors (Table 6). By managing the shareholder base on a regular basis, IR professionals know who enters and exits the base and when, and can choose a form of communication suitable for each type of investor.

Another benefit of shareholder base management reported by 16 companies in the sample is the possibility of speeding up communication with investors. When IR professionals have access to precise and timely information on the trading of the shareholders, they have better opportunities for communication and can carry out their work more efficiently. It is also an advantage to be able to design different strategies for different target groups, as reported by 15 of the responding companies. By managing the shareholder base, IR professionals can classify shareholders in groups (such as natural persons, domestic investors and foreign investors), each one of which may be approached with a different strategy.

Likewise, 15 companies recognized a benefit in the possibility of monitoring IR performance indicators. According to IBRI and Bovespa (2007), such indicators can express, among other parameters, liquidity, shareholder base composition and the number of contacts made over a given period. Finally, nine companies saw as a benefit the ease with which shareholder base management allows to draft IR reports, while four companies mentioned the greater objectivity achieved in meetings with investors.

Table 6. Benefits and difficulties associated with shareholder base management

Characteristics	Variables	Number of Companies N=20
Benefits	Speed up communication with shareholders	16
	Make report writing easier	9
	Monitor IR indicators	14
	Design different strategies for different target group	15
	Monitor evolution of purchases and sales	18
	Target potential investor	18
	Others	4
Difficulties	Large number of investors	4
	Few forms of contacts	5
	Difficult to locate fund managers	7
	Few software options	8
	Undersized IR Departments	8
	Access to potential investors difficult	0
	Others	1

Source: The authors.

As stated above, shareholder base management has also been associated with difficulties (Table 6). In this study, the most frequently reported difficulties were lack of software options (n=8) and undersized IR departments (n=8). The former item was also mentioned as an obstacle to the use of software for shareholder base management. The difficulty in purchasing technological tools was found to be directly related to the small size of IR departments. Understaffed IR departments without software tools will find it more difficult to carry out their tasks and they may not achieve the efficiency required to obtain the benefits associated with good-quality shareholder base management.

Seven companies mentioned difficulties in locating asset managers. CVM currently makes it possible to search the database of Brazilian assets using the identification numbers assigned by the national registry of legal persons (CNPJ), but this is not possible with foreign funds. To locate foreign asset managers, companies claim they have to resort to paid information services, which may in some cases be inaccessible.

In addition, the limited number of forms of contact with the shareholders was felt to be a problem in the shareholder base management of 5 companies. A single company reported difficulties in grouping assets around their principal managers.

Finally, the companies were asked about the use of indicators to evaluate shareholder base management performance. As shown in Table 7, more than half the companies (11 vs. 9) have still not adopted such indicators. In five companies the evaluation was based on the indicator *liquidity* (that is, the more concentrated the shareholder base, the smaller the volume of traded shares) and on reports covering the largest purchases and sales over a given period. Four companies used as indicator the expansion of the shareholder base, while three companies preferred the number of interactions between buyers and sellers of shares as they were putting together a shareholder profile. Only two companies measured shareholder base management performance by the evolution in share prices, with or without comparison to the performance of the main index on the market.

Table 7. Indicators of shareholder base managemen performance

Characteristics	Variables	Number of Companies N=20
Use of indicators	Yes	9
	No	11
Specific Indicators	Share price	3
	Liquidity	5
	Expansion of shareholders base	4
	Shareholders largest's purchases and sales	5
	Interactions with sellers and buyers	4
	Shareholders profile analysis	4

Source: The authors.

As for the relation between the use of indicators and company size, the study reveals that companies with revenues over BRL 1 billion in 2007 were more likely to use indicators of shareholder base management performance. In fact, only two of the nine companies using indicators were below the BRL 1-billion threshold.

In order to analyze the companies using the indicator *liquidity*, data were collected covering the daily trading figures of all the participating companies. Average values were calculated for the first two and last two months of the period January 1, 2007 to February 28, 2009.

The study shows that even in companies adopting the indicator *liquidity*, the volume of traded shares decreased significantly, suggesting that shareholder base management in itself may not be enough to prevent loss of liquidity. Table 8 shows that all five companies employing the indicator *liquidity* to evaluate shareholder base management performance experienced a decrease in traded volume greater than the Ibovespa index, which increased by 3.9%. Only two of the five companies came below the average decrease in the volume of traded shares.

Table 8. Evolution of average daily volume of traded shares in companies employing the indicator *liquidity*

Characteristics	Variables	Number of Companies
		N=5
Liquidity	Ibovespa	3,9%
	Average of participating companies	-68,9%
	Company A	-36,7%
	Company B	-86,0%
	Company C	-86,6%
	Company D	-74,8%
	Company E	-60,4%

Source: The authors.

The question of share market value was also analyzed for the three companies employing the indicator *share price evolution* to measure shareholder base management performance (Table 9). Likewise, the shares of all three companies were depreciated in relation to the Ibovespa index, although two of them performed better than the average of the companies participating in the study.

Table 9. Share market value of companies employing the indicator *share price evolution* to measure shareholder base management performance

Characteristics	Variables	Number of Companies
		N=3
Share market value	Ibovespa	-16,0%
	Average of participating companies	-53,4%
	Company A	-47,8%
	Company B	-87,7%
	Company C	-24,8%

Source: The authors.

However, other market variables outside the control of IR professionals can directly influence share prices and liquidity. It should be pointed out that the period of analysis includes the time prior to and following the conflagration of the American credit crisis which produced a substantial negative impact on the market from September 2008 onwards. The fact that the crisis impacted economic sectors to varying degrees may have influenced our findings.

Our study reveals that, despite difficulties, the sampled companies were generally managing their shareholder bases using either software or spreadsheets. Companies using shareholder base management software and monitoring trading on a daily basis can directly benefit from communication with their investors and gain greater agility and efficiency in their IR activities. However, as observed in the present study, few companies use shareholder base management and performance indicators consistently, suggesting the need for considerable improvement at the hands of qualified IR professionals employed by Brazilian companies in the New Market listing segment of the BOVESPA stock market.

5. Conclusions

The present study is an analysis of 21 questionnaires on shareholder base management practices completed by Brazilian companies in the New Market listing

segment of the BOVESPA stock market. Despite being practiced by virtually all the responding companies, shareholder base management is mostly performed using simple spreadsheets which are unlikely to speed up communication with investors.
The lack of technological tools on the market to help IR professionals communicate with shareholders was found to be one of the major every-day obstacles to the development of IR activities. Today, most IR departments in Brazil remain undersized and relatively inefficient.

Among the most important benefits of shareholder base management are greater agility in the communication with the shareholders, the monitoring of the trading of shares and the targeting of potential investors.

The combination of shareholder base management and efficient communication with shareholders can make a significant difference in IR actions and help achieve the desired level of IR performance indicators.

The results of the study are not directly extrapolable since our sample was non-probabilistic, but they do offer interesting insights into the characteristics of IR activities and shareholder base management practices in the companies in the New Market listing segment of the BOVESPA stock market subject to the highest level of corporate governance requirements.

Future research efforts should include a study of shareholder base management of companies in different Bovespa segments of corporate governance, a comparison of shareholder base management performance of companies belonging to the same Bovespa segment of corporate governance, and an analysis of the influence of shareholder base management upon shareholder base composition and upon the price and liquidity of a company's shares.

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