THE IMPACT OF CHANGES IN LEADERSHIP STRUCTURES ON THE ACCOUNTING PERFORMANCE, CONTROLLING FOR THE FIRM SIZE EFFECTS

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2006

الجامعة الاسلامية العالمية ماليزيا
INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA
اونيۏرسيتي اسلام انتارابڠسا مليسيا

ABSTRACT

Due to the recent waves of corporate scandals, corporate governance (CG) is now at the heart of the overall agenda. These scandals have prompted various tools that can be used to minimize the future risk of malpractices. This has contributed to the introduction of Malaysian Code of Corporate Governance (MCCG) 2001. In order to have a good CG, MCCG 2001 recommends the separated roles of chairman of the Board and the CEO in a company. This study empirically examined the relationship between the changes in the leadership structures and the companies' performances, controlling for firm size effect from the accounting point of view. The sample of 30 companies that have leadership structure changes during the period under review, i.e. from year 2000 to 2004, are selected and their companies' annual reports are extracted from Bursa Malaysia's website. This study uses descriptive statistics, univariate and multivariate regressions to test the hypotheses. The results are inconsistently supported the hypotheses whereby big firms are more beneficial by having single executive playing the roles of both CEO and chairman of the Board while small firms are more advantageous by having two separate executives in both CEO and chairman of the Board. Nevertheless, this study also realizes some limitations like the small sample size, small number of independent variables included in the models, short period of time for the analysis under review, non-thorough size proxies selected to represent the firm size, untested reasons for changes in the leadership structure, and the sample is only restricted to the firms that have experienced changes in the leadership structure.

ملخص البحث

أجمع موضوع إدارة الشركات، بسبب الموجات الأخيرة من الفضائح يتخذ مجال الصدارة في القضايا العامة .ونظرا لكثرةأحداث الفضائح المتعلّقة بالشركات مؤخرا،فإنّ موضوء إدارةالشركة (سي جي) أصبحت تتصدر قلب جدول الأعمال العام الآن" . وقد دفعت هذه الفضائح "بالسلطات" إلي إنشاء الوسائل المختلفةالتي من شأنها إتستعمالها لتقليل الخطر المستقبلي الناتجة من سوء التصرف الإدارى.وقد ساهمت هذه "الفضائح" فى دفع السلطات الماليزية إلى إنشاء الشفرة الماليزية لإدارة الشركة (إم سي سي جي) فى2001.ومن اجل الحصول على أنظمة إدارة جيدة للشركات، أوصى القانون الجديد لعام2001 بان يتكون هنالك تفصيل كامل بين، أدوار رئيس المجلس الإداري والمدير التنفيذي في الشركة الواحدة. وقدقامت هذه الدراسة التجريبية الحالية بالبحث عن طبيعة العلاقة بين التغييرات في تراكيب القيادة وأداءات الشركات، مع وضع تأثيرعامل حجم الشركة تحت السيطرة من وجهة نظر المحاسبة. وتمت اختيارعينة تتكون من30 شركة التي حدثت فيها تغيرات فى القيادة الهيكلية أثناء الفترة تحت المراجعة،اى الفترة: من العام 2000 إلى 2004. وتمت جمع التقارير السنوية لهذه الشركات من البورصة الماليزية. واستخدمت هذه الدراسةأدوات الإحصاء الوصفي، والتحليل الإرتدادىالآحادي والمتعددة المعامل لإختبار الفرضيات. إن نتائج هذا البحث تدعم الفرضيات بشكل متضارب حيث أسبتت النتائج أن الشركات الكبيرة أكثراستفادة وذالك لأن المدير التنفيذي فيها يلعب أدوار كلا من المدير التنفيذي ورئيس المجلس الإداري في آن واحد. أما من الناحية الأخرى فقد أظهرت النتائج أن الشركات الصغيرة هى الأكثراستفادة وذالك بكون المنصبين التنفيذيين منفصلين -أى منصب المدير التنفيذي ورئيس المجلس الإداري- فى الشركة الواحدة. على الرغم من هذا،فإن لهذه الدراسة تعانى من بعض التقييدات التي حدت من شأنها : من بينها صغرحجم العينة ،وقلةعدد العوامل المتغيرة المستقلة التى تضمنتها النماذج،وكذالك قصر الزمنية تحت المراجعة،و كذلك عدم الدقة في إختيارالعامل المناسب لتمثيل تأثيرحجم الشركة،وكذالك لم تتم في هذه الدراسةإختبارأسباب التغييرات في تركيب القيادة، واخيرا كون العينة مأخوذة فقط من الشركات التي واجهت تغيرات في تركيب القيادة.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science in Accounting.

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I certify that I have read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science in Accounting.

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DECLARATION

I hereby declare that this thesis is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

Name: Amal Hayati Ahmad Khair

Signature.. Date . ……………………….

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Affirmed by Amal Hayati Ahmad Khair.

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Signature	Date

This dissertation is dedicated to my late father, Ahmad Khair Taib, who has been called by the Creator on 7 February 2004.

ACKNOWLEDGEMENTS

In the name of Allah, the Most Gracious and the Most Merciful. Praise be only to Allah Al Mighty for His bounty and blessing showers upon us, and peace be upon prophet Muhammad SAW, his family, his companions, and his followers until the end of the day.

The effort which culminated in the writing of this dissertation owes a great deal to a number of people. Firstly, special thanks go to my late respected supervisor, Dr Unvar Rahman bin Abdul Muthalib, for his unfailing supports from the beginning until chapter 5 of this dissertation. Secondly, all throughout his appointment as the co-supervisor, my deepest appreciation especially goes to the honorable and respected Associate Professor Dr Hafiz Majdi bin Ab Rashid. It should be admitted that it would be impossible for me to get this dissertation completed without the help, support, motivation, understanding, time, tolerance, guidance, comments, suggestions, and advices given by Associate Professor Dr Hafiz Majdi bin Ab Rashid. Thirdly, many thanks go to all academic staffs of Department of Accounting for their kindness, cooperation and friendliness in rendering their assistance to me. I am also highly indebted to staff at IIUM library, and National library for giving a great help in making available all the relevant literature and related information I needed.

For their teaching of the finer points in my turbulence life, I owed the greatest indebtedness of all to my late father, Haji Ahmad Khair bin Taib and my beloved mother, Hajjah Jamaliah binti Ahmad, whom have always been my inspiration, providing me with intrinsic and extrinsic motivations and prayers to continue my studies. Last but not least, my five siblings, Amali, Amany, Ahmad Shubly, Amal Wahdi and Awatif Deena, my beloved and understanding husband, Mohamad Nazri bin Abd Karim, and my dearest son, Aasif Naaeil, who have always stood ready to help, and their steady supportive attitude has made a positive difference throughout this undertaking. Finally, to all individuals who have contributed any amount of help and whose names are not mentioned in person, I would like to thank all of you very much and pray that may your best reward come from the Almighty Allah.

CONTENTS

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LIST OF ABBREVIATIONS

BV	Book Value
CAPM	Capital Asset Pricing Model
CEO	Chief Executive Officer
CG	Corporate Governance
CLS	Combined Leadership Structure
CLS2SLS	Change from Combined Leadership Structure to Split Leadership Structure
COB	Chairman of the Board
CLS2SLS x ‘sqrtBV’	Change from CLS to SLS times Square Root of Book Value of Capital
CLS2SLS x ‘sqrtMV’	Change from CLS to SLS times Square Root of Market Value of Capital
CLS2SLS x ‘sqrtSales’	Change from CLS to SLS times Square Root of Book Value of Sales
EBIT	Earnings Before Interests and Taxes
EPS	Earnings Per Share
H1	Hypothesis 1
H2	Hypothesis 2
H3	Hypothesis 3
LS	Leadership Structure
MCCG	Malaysian Code of Corporate Governance
MV	Market Value
MVA	Market Value Added (MVA = MV of capital – BV of capital)
OCF/S	Operating Cash Flow to Sales ratio
OCF/TA	Operating Cash Flow to Total Assets ratio
OI/TA	Operating Income before Depreciation, Interest, and Taxes to Total Assets ratio
OLS	Ordinary Least Squares
PPE/TA	Property, Plant and Equipment to Total Assets ratio
ROA	Return on Assets
ROE	Return on Equity
SC	Securities Commission
SIMM	Single Index Market Model
SLS	Split Leadership Structure
SLS2CLS	Change from Split Leadership Structure to Combined Leadership Structure
sqrtBV	Square Root of Book Value of Capital
sqrtMV	Square Root of Market Value of Capital
sqrtSales	Square Root of Sales
VIF	Variance Inflation Factor

CHAPTER 1

INTRODUCTION

1.1 BACKGROUND AND RESEARCH PROBLEM

Due to the wave of various scandals in the world market, all countries have experienced the terrible economic crisis. The condition was even worse especially when the 1997/1998 Asian financial crisis badly affected in most Asian countries. Inevitably, this scenario has significantly changed the landscape of the affected countries' corporate governance, including Malaysia. One of the examples of the scandals that happened in Malaysia during the 1997/1998 Asian financial crisis is when Renong Berhad was bailed out by funds amounting to RM2.34 billion (Jomo, 1998). This clearly shows that stock market rules were manipulated to serve the interests of the politically influential individuals. Many of the political individuals' business practices were officially sanctioned. They are believed to have acted on political instructions to take over the Philippines National Steel Corporation with funds that came from 'a syndicated loan amounting to US$800 million from Malayan Banking, Bank Bumiputera, Bank of Commerce and Rashid Hussein Bank, all of which breached their single customer limits' (Jomo, 1998).

Since 1997 onwards, because of those scandals, the topic of corporate governance has been hotly debated and received considerable attention from both practitioners and academicians in Malaysia. One corporate governance issue that has been widely discussed is whether a firm should have one person holding both positions of Chief Executive Officer (CEO) and Chairman of the Board (COB) (which will be termed as Combined Leadership Structure – CLS – thereafter) or different persons holding the CEO and COB positions (which will be termed as Split

Leadership Structure – SLS – thereafter). However, with the introduction of Malaysian Code of Corporate Governance (MCCG) in 2001, all firms are recommended to have different persons holding the CEO and Chairman positions in order to ensure the balance of power and authority.

Numerous studies have been conducted to test the impact of the separation of ownership from control on performance of US firms (e.g. Jensen and Meckling, 1976; Fama, 1980; Jensen, 1983; Weisbach, 1988; Davis, 1991). The focus of this study is on leadership structure which is the issue of whether the CEO should also be the COB. Basically there are four different groups of views on this area of leadership structure. The first group argues that firm value will increase if it employs SLS (Fama and Jensen, 1983; Rechner and Dalton, 1991; Pi and Timme, 1993). The second group suggests that CLS will boost firm value (Donaldson and Davis, 1991; Dahya et al., 1996; Brickley et al., 1997; Bhagat and Black, 1998). The third group however, does not find any significant impact of leadership structure changes on firm value (Berg and Smith, 1978; Chaganti et al., 1985; Daily and Dalton, 1993, 1997; Baliga et al., 1996; Forsberg, 1999). The last group argues that the optimal leadership structure may change over time (Dahya and Travlos, 2000).

Interestingly, only Palmon and Wald's (2002) study has quantitatively analyzed the impact of firm size on the relationship between leadership structure and firm value. They find that small firms benefit more from the clarity and decisiveness of decision making under single executive, while large firms benefit more from the check and balances of having two executives in the CEO and COB positions.

All of the above studies were conducted in Western countries, either in the United States or the United Kingdom. To date, there is no study conducted in Malaysia to examine this issue except the study by Abdullah (2004). Abdullah (2004) investigates the roles of board independence and CEO duality on a firm's performance relying on financial ratios, namely ROA, ROE, EPS and profit margin. However, his study did not take into consideration on the firm size. His findings, generally, suggest that neither board independence, leadership structure nor the joint effects of these two showed any relations with firm performance.

1.2 MOTIVATION OF THE STUDY AND RESEARCH OBJECTIVES

Some previous studies suggest that separation of CEO and COB positions to two different individuals (SLS) reduces agency costs and leads to enhanced firm performance (Fama and Jensen, 1983; Rechner and Dalton, 1991; Pi and Timme, 1993). These researchers found that firms with SLS consistently outperformed firms with CLS. Furthermore, study by Palmon and Wald (2002), which was done in US, has quantitatively controlled for the impact of firm size on the relationship between leadership structure and firm value. The exclusion of firm size as one of the explanatory variables may be a contributing factor for weak results and lack of consensus in some of the previous studies.

In Malaysia, no studies have been conducted to test impact of firm size on the relationship between leadership structure and firm performance. In addition, questions have been raised that require explanation on relationship between the leadership structure and the firm value especially after the introduction of MCCG in 2001. This study attempts to show evidence on the effectiveness of the corporate governance recommendation sets out in MCCG 2001 which is applicable to most sizes of firms. Therefore, there is a need to find out whether the changes in the leadership structure affect the firm performance by size. This study will provide some evidence on the effectiveness of corporate governance on firm performance taking into account the size of the firm. The evidence obtained from this study may then assist in determining the optimal leadership structure for Malaysian firms. Optimal leadership structure may in turn lead to better firm performance.

Thus, the specific research objectives that will be addressed in this study are to:

(a) investigate in general, whether the changes in the leadership structure has significant impact on the performance of the firms regardless of the firms' sizes, and

(b) how switching between two alternative leadership structures (CLS and SLS) affects firms and how this impact varies with firm size.

This study uses secondary data extracted from the Bursa Malaysia's website[1] with those companies that experience changes in the leadership structure either from CLS to SLS or vice versa, during the period under review which is from January 2000 to December 2004.

1.3 SIGNIFICANCE OF THE STUDY

This study will contribute to the existing growing body of work that urges the push toward an optimal leadership structure with a particular focus on firm's leadership structure and its changes that have effects on the firm performance especially on different sizes of firms. As noted earlier, prior studies in Malaysia only focus on impact of leadership structure changes on firm performance (Abdullah, 2004). However, this study attempts to investigate the effect of the leadership structure changes on firm performance by firm size adopted from Palmon and Wald (2002).

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[1] Website: http://www.klse.com.my or http://www.bursamalaysia.com

The results of the study may also contribute to the accounting and management curriculum, by explaining the relationship between leadership structure and firm performance by size in accounting or business courses. Such findings are essential because the accounting and management professions are interrelated and thus may provide clearer directions for firms of different sizes on the optimal leadership structure to achieve better firm performance.

1.4 ORGANISATION OF DISSERTATION

This dissertation has five other chapters. The next chapter, i.e., chapter two, discusses the development of literature on leadership structure change's effects on firm performance. The chapter elaborates on earlier studies and the opinions of various researchers on firm performance affected by changes in leadership structure. From this analysis, the parameters for the development of the research hypotheses are set.

Chapter three discusses corporate governance in Malaysia. This includes the development of the Malaysian Code of Corporate Governance in year 2001 and corporate governance practices in Malaysia. Chapter four primarily explains the development of hypotheses and the methodology adopted to operationalize this research. This includes a discussion on the types of data, sampling procedures, measurement scales, data collection procedures and statistical analyses adopted in this study.

Chapter five presents and discusses the findings of the study with reference to the results of prior studies. This chapter discusses, in particular, the objectives of the study. The discussion starts with the general overview on the effects of leadership structure changes on firm performance. Then, the chapter focuses on the effects of leadership structure changes on firm performance by firm size and determines whether the hypotheses formed can be accepted or rejected using statistical inferences.

Chapter six, i.e., the final chapter, concludes the overall findings of the research and explains the implications of this research on business ethics and the academic curriculum. This chapter also discusses the limitations and directions of future researches in the areas of accounting and management curriculum.

CHAPTER 2

LITERATURE REVIEW

2.1 INTRODUCTION

This section discusses prior studies thereby analyzing the causes and the effects of alternative types of Chief Executive Officer (CEO) and Chairman of the Board (COB) personnel changes. One important duty of the Board of Directors is to evaluate the senior management of the corporation and replace them if they fail to perform well. In fact, the COB, as defined by Faleye (2003), is a corporation's chief decision control agent. He is not only responsible for the working of the board, but also to ascertain that the board adequately ratifies and monitors the strategy initiated by the CEO. The CEO, on the other hand, is not only a head of the organization's management hierarchy (Fama and Jensen, 1983) but also a corporation's chief strategist and is responsible for initiating and implementing companywide plan and policies (Faleye, 2003).

Even though both CEO and COB have different responsibilities and job functions, however there is an issue of whether they should be held by one person or separate individuals. However, because of the recent growing world-wide pressures by regulators and the public at large to reform corporate governance (CG) practices, split leadership structure (SLS)[2] has received considerable attention. Under the Best Practice in CG of Malaysian Code of Corporate Governance (MCCG) January 2001, there should be a strong independent element of the board if the roles of both COB and CEO are combined. Furthermore, whether or not the roles of COB and CEO are

[2] Two separate individuals holding the positions of the CEO and the chairman of the BOD of a corporation.

combined, the board should identify a senior independent non-executive director of a board in the annual report to whom concerns (i.e. company matters) may be conveyed. Moreover, if the company decides to combine the roles of COB and CEO, it should be known to the public. However, in the event that the combined leadership structure (CLS)[3] is adopted, MCCG does not object provided that at least one third of the membership of the board should be made up of independent non-executive directors in order for the board to be effective (Part 2, AA (III) of the MCCG 2001).

Various studies have been conducted to ascertain the optimal leadership structure of a firm. However, researchers have come up with advantages and disadvantages for both leadership structures. The three main advantages of SLS are (a) it is essential for board effectiveness since chairman CEO cannot perform control functions apart from his/her personal interest due to separate leadership structure (Jensen, 1993), (b) to provide balance to the board and also offers a cushion for the possibly over-ambitious plans of the CEO (Stiles and Taylor, 1993; Blackburn, 1994), and (c) to have an independent chairman who may provide a valuable 'outside' perspective, which may (as suggested by Pettigrew, 1992) contribute to the development of the organization's goals and objectives and strengthen the link between the company and its environment, thereby, improving CG. The five disadvantages of SLS identified in the literature are (a) to lead to the cost of sharing information between the CEO and the COB (Brickley, Coles and Jerrel, 1997), (b) to create rivalry and conflicts between the CEO and the COB (Baliga et al., 1996), (c) to create confusion due to the existence of two public corporate spokepersons and the opportunity for the third parties to take advantage of the situation (Baliga et al., 1996), (d) to curtail innovations and entrepreneurship (Baliga et al., 1996), and (e) to dilute

[3] One person holding both positions as the CEO and the Chairman of the BOD of a corporation.

the power of the CEO to provide effective leadership of the company by increasing the probability that actions and expectations of management and the board are incongruence with each other (Daily and Dalton, 1997; Baliga et al., 1996; Alexander et al., 1993).

On the other hand, the advantages of CLS include, among others (a) providing clear-cut leadership and focus in the conduct of the corporation's operations (Baliga et al., 1996; Boyd, 1995; Anderson and Anthony, 1986; Stoeberl and Sherony, 1985), and (b) no cost of transferring information involves because of the same person holding both positions (Brickley, Coles and Jerrel, 1997). However, the disadvantages of CLS are (a) constrains board independence and reduces the possibility that the board can properly execute its oversight and governance role (Baliga et al., 1996; Millstein, 1992; Dobrzynski, 1991; Fizel and Louie, 1990; Lorsch and Maclver, 1989), (b) the lacks in the separation of decision management and decision control which consequently leads to the competition for survival (Fama and Jensen, 1983), and (c) making it difficult for insecure directors to be honest when evaluating firm performance which, in turn, leads to long-term organizational drift (Carver, 1990).

2.2 A REVIEW OF THE EMPIRICAL EVIDENCE ON BOTH LEADERSHIP STRUCTURES

In spite of the advantages and disadvantages of both leadership structures, there are mixed empirical evidence on the superiority of either leadership structure. For example, Faleye (2003) shows that there is no one universal leadership structure appropriate for all firms due to the differences in specific circumstances of individual organization. He addresses three issues of firms' specific circumstances, i.e., organizational complexity, CEO reputation, and the potential for agency conflicts affecting the relative costs and benefits of dual leadership (governance substitution). The three proxies are employed for both organizational complexity [i.e. firm size, sales growth opportunity, and nature of firms operations – measured through the ratio of net property, plant and equipment to total assets (net PPE/TA)] and CEO reputation (i.e., CEO's tenure, board membership, and whether CEO was appointed from outside) and four proxies for governance substitution (i.e., managerial equity ownership, unaffiliated block ownership, board size and board independence).

Faleye (2003) obtained the data for 2,166 firms of which 1,467 are CLS firms and the remaining 699 are SLS firms. The governance variables data are extracted from 1995 proxy statements filed with the Securities Commission (SC). In cases of data unavailability in the proxy statements, it is extended with data from annual reports and company web sites. The financial data for year 1990 to 1994 are gathered from Compustat database and are averaged over those years. Control variables used in each regression includes (a) ratio of long term debt to total assets to control for differences in firm's contracting environment, (b) a separate intercept term for each two-digit SIC codes to control for industry effects, and (c) CEO's age.

Faleye (2003) has three hypotheses, namely (a) the desirability for CLS increases with organizational complexity because the cost of vesting chairman and CEO roles in separate individuals likely outweighs the benefit of independent control in complex organizations, (b) there is a positive association between CLS and CEO's reputation which means a reputable CEO is less likely to engage in value-diminishing behaviour, thus reducing the need for SLS, and (c) if governance attributes impose a sufficient constraint on the CEO, it may not be necessary to incur the additional costs of separating the CEO and chairman positions which means it is cost effective to have CLS.

Faleye (2003) uses both univariate and multivariate tests. The results show that organizational complexity and CEO reputation are more likely to blend CEO and chairman positions. Under the complexity hypothesis, both mean and median of total assets in 1994 are higher for firms with CLS than those with SLS and are significantly different at 1 percent level. However, neither the net PPE/TA nor the sales growth is significantly different for both CLS and SLS sample firms. The sales growth is significantly different at 10 percent level only. Similarly, under the CEO reputation hypothesis, CLS scores significantly higher on each of the reputation measures (both mean and median for CEO tenure, mean outside board service and mean CLS are appointed from outside and are significantly different at 1 percent level). However, for the governance substitution hypothesis, while univariate test results show no significant differences on each measure, probit regressions results show a negative coefficients on managerial equity ownership and board size (significant at 0.01 percent level). Firms with either small boards or high managerial ownership consider the monitoring capabilities of alternative governance provisions before incurring the additional costs of separating both positions. Generally, these results indicate that firms do consider the costs and benefits of alternative leadership structures and that pushing all firms to common leadership structure may be detrimental due to differences in individual organizational circumstances.

However, one of the limitations identified in Faleye's (2003) study is that the number of SLS firms (699) is far less than the CLS firms (1467) included in the sample which might affect the validity of the results obtained. Furthermore, Faleye (2003) does not explain the reason why he controls for the CEO's age under each regression conducted.