

DO BOARD COMMITTEES' FEATURES AFFECT CORPORATE GOVERNANCE DISCLOSURE? – THE CASE OF FINANCIAL INSTITUTIONS

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Abstract

The purpose of our empirical study is to assess the relationship between board committees features and the level of disclosure in case of banking institutions listed on London Stock Exchange. The research methodology used for achieving our goal is based on econometric analysis using statistical tools - correlations for identifying the relationships and regressions for assessing them - all of these being performed using SPSS software. In this respect, firstly, we developed a disclosure index made of three sub-indices, one for each type of disclosure: mandatory, recommended and voluntary. The main features considered for assessing board committees: their existence and independence of membership. The results of the performed analysis reveal significant positive influences of board committees features on the level of disclosure, thus confirming our assumptions that the higher the quality of board committees, the higher the level of disclosure.

Keywords: banking, corporate governance, board committees, disclosure.

JEL Classification: M10, G30.

Introduction

Most recently corporate failures and accounting scandals proved to have been caused by the lack of good corporate governance, that have adversely affected public confidence in the reliability of corporate and financial reporting. All these situations gradually lead to “a wake-up call” to the need for better corporate governance and transparency among companies all over the world. Consequently, disclosure and the quality of corporate governance system are appreciated as closely related concepts - the higher the level of transparency, the better the quality corporate governance practices.

The effect of increased disclosure is improved transparency, which is identified as one of the main aims of corporate governance provisions (OECD, 2004, Section V, pp. 22): “The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.” Basing on this background, we focused on corporate governance disclosure, analyzing possible influences over it coming from corporate governance dimensions.

Basing on this background, our paper is aimed to identify possible associations between board of directors committees' features and the level of disclosure through annual reports in case of banking institutions listed at London Stock Exchange. The main reason of focusing our research on the board of directors' committees was their increasing role in the corporate governance mechanism. Thus, the aim of our study is to provide an answer to the research question “Do corporate governance features affect transparency?” by assessing the relationship between board of directors' committees and the level of corporate governance disclosure.

The research methodology used for achieving our goal is based on econometric analysis using statistical tools - correlations for identifying possible relationships and regressions for assessing them - all of these being performed using SPSS software. In this respect, firstly, we developed a disclosure index made of three sub-indices comprising information appreciated as mandatory, recommended and voluntary to be disclosed. The analysis performed followed two steps: the first one based on a correlation test between the board committees' attributes and the level of disclosure, using Pearson coefficient, followed by a regression analysis comprising only those attributes that proved to be significantly correlated to the level of disclosure. The main committees assessed were: nomination, remuneration, risk and audit committee and their features (e.g. existence, independence).

The paper proceeds as it follows. Firstly, we pointed out the major studies conducted on the same topic and we developed particular hypotheses related to corporate governance attributes over the level of information disclosed in case of financial institutions listed in UK. After explaining in detail the data collection method and empirical analysis design, we tested our hypotheses using information from sampled banks' websites and we developed two models revealing significant influences of board committees' features over corporate governance disclosure in case of credit institutions listed at London Stock Exchange. Finally,

we provided our research findings and discuss their implications, closely related to previous studies focused on the same goal.

Literature review and hypothesis development

In the latest years, researchers became interested in testing possible relationship between board committees and corporate governance disclosures, their results often leading to positive associations (Cheung, et al., 2010; O'Sullivan et al., 2008; Cormier, et al., 2010).

Audit committee, from the agency theory perspective serves as a means of reducing information asymmetry, managerial opportunism and improving disclosure quality (Cheung et al., 2010), thus protecting the investors (McDaniel et al., 2002). According to previous studies *the presence of an audit committee* in the governance structure is beneficial, considering the following reasons:

- it ensures a reliable *financial reporting* by reducing the incidence of errors and other irregularities (McMullen, 1996), as well as the likelihood of accounting fraud (Peasnell et al., 2001; Dechow, et al., 1996), by attesting external financial reporting (Bradbury, 1990);
- it is a monitoring mechanism that enhance the breadth of relevance and reliability of *annual reports* (DeZoort, 1997; Wolnizer, 1995) and improves information quality conveyed to external parties (Abbott, et al., 2004; Carcello and Neal, 2000);
- it maintains the quality of *control systems* and financial accounting information disclosure, too (Collier, 1993).

The main role of the *nomination committee* is to ensure a good governance structure, made up of qualified and knowledgeable people representing the best interests of the membership. Thus, the electoral responsibility of such a committee is to nominate possible candidates for managerial positions within a company, by examining the skills and characteristics that are needed, that are then voted into office by all of the members of the board. Usually, candidates running for office outside of the nominating committee's choices stand little chance of election.

The nomination committee has two major contributions in ensuring good corporate governance structure within an organization, namely:

- it contributes to the board effectiveness as monitoring device, by selecting fewer “grey” directors (Vafeas, 1999)
- it protects the interest of the minority shareholders, by giving them more possibilities to advocate a nominee, which is important especially in case of organizations with large controlling ownership (Jensen 1993; Shivdasani and Yermack, 1999).

On the other hand, there are opinions stated that nomination committees are vulnerable to manipulation by the controlling leaders of the company and that this is the main reason for their formation.

The remuneration (compensation) committee can also contribute to sound governance, through its positive role in the top management control ensured by its power to define the remuneration mechanisms and to align the management's and the shareholders' interests (Main and Johnston 1993; Conyon and Peck 1998; Laksmana 2008).

Just, the existence of the main board committees proved to be not enough in order to ensure quality to disclosure (Forker, 1992). That is why, prior studies tried to assess its effectiveness through *the independence and expertise of its members*. Corporate governance codes do not specify the required proportion of independent non-executive directors for these committees.

From the agency theory's perspective, the quality of monitoring of corporate disclosure is associated with the inclusion of more independent directors on a committee (Collier and Gregory, 1999). Dominance of a board by executives and insiders can deter the creation of active, independent committees (Klein 1998; Mendez and Garcia 2007), while outside directors indicates less interference from management to exercise their independence, and better quality of financial reporting. There is also evidence that audit committees comprising solely of *independent directors* tend to be more active and effective in their performance and disclosing information to stakeholders (Raghunandan et al., 2001).

Thus, board committees are seen as important structures, helping at improving the quality of governance. Thus, the nomination and remuneration committee is useful at ensuring a good governance structure made up of qualified and knowledgeable members, having appropriate and supportable payment programs, aligned to shareholders' interests, while the audit committee and risk committee - that was not

studied before at its real importance, especially in case of banking institutions - have a key role in monitoring activity and reducing risks.

In conclusion, the presence of board committees is appreciated as a feature of a good governance structure, whereas its quality, measured through the number of the independent members, increases its soundness, thus improving transparency, too. Hence, these arguments, leads to the following hypotheses:

The extent of disclosure is positively associated with the existence (H1) and quality of board committees (H2).

Empirical design and results

The sample of our paper is made of all credit institutions listed on London Stock Exchange (46 banks according to the information available for the year 2011). Data collection was based on information provided by banks' websites, the process being divided into two parts. Firstly, we measured the level of disclosure by using a checklist developed in this respect. For this, we used banks' annual reports for year 2010 by downloading them from their websites. Secondly, we collected data related to banks' governance system by searching in addition through their financial statements and general information provided by their website.

Because the main purpose of our study is to identify possible associations between corporate governance dimensions and the level of disclosure, two sets of dependent and independent variables for performing the correlation analysis are needed.

Thus, for measuring the level of disclosure, which is *the dependent variable*, we made use of a Disclosure Index (TD) especially developed in this respect that mainly consists of three sub-indices, each of them measuring a different type of disclosure, namely: *mandatory (MD)*, *recommended (RD)* or *voluntary (VD)*. These indices measure the extent of each type of disclosure, being calculated as a ratio of the total number of items disclosed to the maximum possible number obtainable for each category of disclosure. Thus, we compiled three separate lists of disclosure, namely:

- a checklist of *mandatory disclosures* for entities listed at London Stock Exchange, based on the most recently Corporate Governance Disclosure Checklist (Deloitte, 2011), considering The Listing Rules and The UK Corporate Governance Code, as well as the recently requirements supplemented by The Disclosure and Transparency Rules on Audit Committees and Corporate Governance Statements (2008), The Revised Version of the Turnbull Guidance on Internal Control (2005), The Guidance on Audit Committees (2010). This checklist comprises 44 items divided into six main categories of information related to general aspects, leadership, effectiveness, accountability, remuneration and relation with shareholders.
- a checklist of *recommended disclosures* based on OECD Principles, which propose that the corporate governance framework should ensure that timely and accurate disclosure is made on companies' "financial situation, performance, ownership and governance" (OECD, 1999). This checklist comprises 51 items divided into four categories, according to the disclosures required by the principles, as follows: rights of shareholders and key ownership functions, equitable treatment of shareholders, disclosure and transparency, responsibilities of the board.
- a checklist of *voluntary disclosure*, based on the Standard & Poor's list of 98 transparency and disclosure questions used for its study developed for Europe in 2003. This checklist comprises 88 items divided into three categories outlining ownership, company performance and boards (governance). This approach of developing the disclosure index was often used in prior studies aiming on the same goal (Mangena and Tauringana, 2007; Tsamenyi, et al., 2007; Aksu and Kosedag, 2006).

After joining the three separate checklists, a final checklist of 142 items was structured, basing on S&P's study, into 4 main categories: *general provisions* (2), *ownership structure and investor rights* (43), *financial transparency and information disclosure* (46), *board structure and process* (78). This was supplemented with 8 additional items used in at least one previously published study focused on the same topic and 15 own items, thus resulting a comprehensive checklist list of 167 items consisted of 31 mandatory, 54 recommended and 82 voluntary disclosures.

For developing the disclosure index each item of the checklist was scored using *binary classification*, each issue from the list being treated a dummy variable, where "1" indicates that the annual report discloses the information and '0' indicates that there is not disclosed any information about that issue. The disclosure index was computed using an *un-weighted scoring approach* of the disclosure items, basing on the

assumption that each item of information disclosure is of equal importance in the corporate information users' decision-making process. The main reason to do so is related to the subjectivity that might occur when different weights are assigned to reflect the importance of certain types of information. Our approach is supported by most prior studies aimed to develop such an index of disclosure, unlike weighted scores, which were rarely used before (Barako, et al., 2006; Cheng and Courtenay, 2006; Patelli and Prencipe, 2007).

The independent variables consists of a corporate governance dimension that prior studies found to have significant influences over the level of disclosure – board committees, measured through:

- *board committees' existence (B_Com.Exist)* – expressed by the number of board committees (Nomination, Remuneration, Risk and Audit), thus taking values from 0 to 4 according to their number;
- *board committees' quality (B_Com.Qual)* – expressed by the proportion of independent members into board committees membership

For testing our hypotheses firstly we performed a correlation analysis between each dependent variables – disclosure indices (TD, MD, RD and VD) and the corporate governance attribute tested – board committees (existence – B_Com.Exist and quality – B_Com.Qual), whose results are detailed in Table 1.

Table 1. The correlation matrix between variables

		TD_Index	MD_Index	RD_Index	VD_Index	B_Com.Exist	B_Com.Qual
TD_Index	Pearson Correlation	1	,788**	,944**	,893**	,589**	,468**
	Sig. (2-tailed)		,000	,000	,000	,000	,001
	N	46	46	46	46	46	46
MD_Index	Pearson Correlation	,788**	1	,694**	,513**	,713**	,308*
	Sig. (2-tailed)	,000		,000	,000	,000	,038
	N	46	46	46	46	46	46
RD_Index	Pearson Correlation	,944**	,694**	1	,765**	,483**	,483**
	Sig. (2-tailed)	,000	,000		,000	,001	,001
	N	46	46	46	46	46	46
VD_Index	Pearson Correlation	,893**	,513**	,765**	1	,442**	,414**
	Sig. (2-tailed)	,000	,000	,000		,002	,004
	N	46	46	46	46	46	46
**. Correlation is significant at the 0.01 level (2-tailed).							
*. Correlation is significant at the 0.05 level (2-tailed).							

By analyzing the values of Pearson's coefficient we reached to the following conclusions:

- in case of total disclosure index (TD_Index), recommended disclosure (RD_Index) and voluntary disclosure (VD_Index) both attributes tested (the existence of board committees and their independent membership) have a positive influence, but their intensity is just a medium one (between 0,414 and 0,589), being significant with a high probability of 99% (Sig. <0,01).
- in case of mandatory disclosure index (MD_Index), the existence of board committees proved to have the strongest positive influence of all correlations tested (0,713), being significant with a high probability of 99% (Sig. <0,01), too, whereas in case of their independence the positive association identified is the lowest one (0,308) and has a probability of just 95% (Sig. <0,05).

Presuming that the existence of board committees (e.g. nomination, remuneration, audit and risk committee) is a sign of a good governance structure, basing at least on the their ability to ensure a qualified and knowledgeable board composition, having appropriate and supportable payment programs, to monitor activity and to manage risks, we expected higher level of disclosure, too, thus hypnotizing that

H1: There is a positive association between the existence of board committees and the extent of disclosure

According to the values of Pearson coefficient and the linear regression results presented below there is a significant positive correlation of medium intensity and a probability of 99% (Sig. <0,01) between

variables tested (0,589 in case of total disclosure), which is explained in 33,2% of cases, according to the linear regression results presented in Table 2. Medium intensity associations with the same significance were identified in case of recommended and voluntary disclosure sub-indices, too, Pearson's values being of 0,483, 0,442, while in case of mandatory disclosure sub-index, the intensity of correlation proved to be the highest one (0,713)

Thus, our first hypothesis (H1) will be accepted and consequently we can stated that the extent of disclosure is positively associated with the existence of board committees.

Table 2. Linear regression analysis results

Coefficients ^a						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	37,522	3,993		9,396	,000
	B_Com.Exist	6,623	1,371	,589	4,836	,000
R Square: .347 Adjusted R Square: .332				F value: 23.386 F significance: .000		
a. Dependent Variable: TD_Index						
2	(Constant)	49,761	2,247		22,145	,000
	B_Com.Qual	10,488	2,989	,468	3,509	,001
R Square: .219 Adjusted R Square: .201				F value: 12.314 F significance: .001		
a. Dependent Variable: TD_Index						

Basing on the premise that the quality of board committees, measured through the number of the independent members, increases its soundness, thus improving transparency as well, we hypnotized that

H2: There is a positive association between the quality of board committees and the extent of disclosure

Pearson coefficient values reveal the existence of a positive correlation between variables tested, having a medium intensity (0,468 in case of total disclosure) and a probability of 99% (Sig. <0,01), which is explained in 20,1% of cases, according to the linear regression results presented in Table 2. Correlation analysis provide a stronger positive correlation in case of recommended disclosure (0,483), while voluntary and mandatory disclosures proved to be less associated with board committees' independence (0,414, respectively 0,308), the last correlation having just a probability of 95% (Sig. <0,05).

Consequently, our second hypothesis (H2) will be accepted, leading to the conclusion that the higher the independence of board committees, the higher the level of disclosure.

Considering the purpose of our research – to find the most appropriate answer to our question “Do corporate governance features affect transparency?” by assessing the relationship between board of directors' committees and the level of corporate governance disclosure, we performed the next step - the regression analysis.

In this respect, we used multiple regression as the method of analysis and Ordinary Least Squares (OLS) as the method of estimation. For developing our models, we start for the general economic model used in prior literature focused on similar goals:

$$Y = \alpha + \beta_1 * F_{it} + e_{it}$$

where, Y is the dependent variable. α is constant, β_1 is the coefficient of the explanatory variable, F_{it} is the explanatory variable (corporate governance features in our case) and e_{it} is the error term (assumed to have zero mean and to be independent across time period).

By applying both “enter” and “stepwise” method, we selected for our models just those independent variables that proved to explain better the influences over the dependent ones, considering R square coefficient values. Also, the analysis of variance performed, using Anova test, helped us measuring the strength of each relationship established, all results being presented in Table 3.

Table 3. Regression analysis using “enter” and “stepwise” methods

Variables	Results according to “Entere” method				Results according to “Stepwise” method			
	TD_Index				TD_Index - Model 1**		TD_Index - Model 2*	
	Coeff.	Sig.	Tolerance	VIF	Coeff.	Sig.	Coeff.	Sig.
(Constant)	37,339	,000				,000		,000
B_Com.Exist	5,401	,000**	,848	1,179	,589	,000	,480	,000
C_Com.Qual	6,293	,032*	,848	1,179	-	-	,281	,032
F value: 15.176 F significance: .000 R Square: .414 Adjusted R Square: .387				F value: 23,386 F significance: .000 R Square: .347 Adjusted R Square: .332		F value: 15,176 F significance: .000 R Square: .414 Adjusted R Square: .387		
*) significant for p-value<0.1 **) significant for p-value<0.05				*) significant for p-value<0.05 **) significant for p-value<0.01				

By using linear regression analysis and applying “enter” method, considering just the attributes that proved to be significantly correlated with the level of disclosure, we identified those independent variables that proved to explain better the influences over each type of disclosure, but the results achieved could not allow us developing a model comprising all attributes.

Therefore, we had to made use of “stepwise” method that helped us selecting just those independent variables that were significant being thus retained for our models. Consequently, we could develop two models for each of these having different level of significance and attributes included, the highest rate of explaining being of 38,7% (Model 2).

In conclusion, both the presence and the quality of board committees proved to be able to explain positive influences over all types of disclosures analyzed, but with different levels of significance.

Conclusions and limitations

The relationship between various attributes of corporate governance and the level of disclosure was a highly debated topic of worldwide research, whose outcomes are mixed. Irrespective of prior studies, which were focused on corporate governance features like board of directors size and independence, CEO duality or various ownership’ features, our study comes to add value to corporate governance literature by testing a corporate governance attribute, which was little explored before - board of directors’ committees. Moreover, because the banking system was little explored on this topic before, we had the chance to enrich the research literature with this empirical study, whose disclosure index developed ensures it as well with originality. The results of the performed analysis reveal positive relationships between board committees’ features tested – namely their existence and independence – and the level of disclosure. Thus we can assert that the higher the quality of board committees, the higher the level of transparency.

Finally, being aware of our study’s limitations, coming from the sample of banks, the limited number of factors and the fact that only one year data were considered for analysis, we are appreciating these as a challenge that give us outlooks for future research.

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