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Board Supervisory Committees and Non-mandatory Regulation – New Zealand Evidence

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This paper contributes to the corporate governance literature documenting that regulation enhances board committee formation and practice in the firm. Following the agency theory, we posits that concentrated ownership will tends to existence of less board committee practice but the presence of regulation will enhance higher board committee formation. Using a sample of NZX listed companies over 2000-2007 (inclusive), we evidence that in non-mandatory regulation like 'comply or explain' increases board committee formation. This study shows that existence of regulation plays a significant role on corporate governance compliance in addition of board composition. The study offers insight to the policy makers to comply with board committee formation even in centralised ownership.

Keywords: Corporate governance, Board of directors, Board committees, New Zealand.

Field of Research: Corporate Governance Regulation

1. Introduction

This paper contributes to the corporate governance literature by documenting the association between board of directors' characteristics and board supervisory committees. Board supervisory committee defines as "a group of committees formed by shareholders of a company to promote their interest and retain accountability of corporate governance through monitoring". Board of director characteristics is one of the important aspects of existing board supervisory committee. Moreover, board supervisory committee is one of the less researched areas over the development process of corporate governance. Understanding the determinants of supervisory committee is important because it affects accountability of corporate governance. Investors prefer existence of supervisory committees due to the indication of higher compliance of corporate governance. Literature does not support to evidence the determinants of board supervisory committees. Moreover, non-mandatory corporate governance regulations permit significant flexibility to best practice compliance and therefore it is important to know the determinants of board supervisory committee.

Non-mandatory corporate governance regulation is always under scrutiny by practitioner, academic and regulators. Consequently, researchers argue that New Zealand corporate governance rules are destroying the value of business (Goldfinch, 2004) due to over emphasising on board of directors. She indicated that the shortage of qualified independent director is the main factor of this fallacy. Moreover, the directors are not enough accountable in compare to other market economy countries and enjoy less monitoring and pressure by the regulators and shareholders (Farrar, 2005).

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Establishment of board committees becomes an integral part of good corporate governance practice. Therefore, most of the corporate governance best practice codes and corporate governance principles recommend for effective board committees. New corporate governance also suggest establishment of audit committee, remuneration committee and nomination committee as minimum criteria of board committee. Establishment of board committee does not guarantee on effective contribution to companies. However, effective audit committee enhance firm performance and effective remuneration committee reduce managerial opportunistic behaviour is well established in literature. Similarly, nomination committee influence recruitment and performance assessment of CEO and board members.

Using a sample of New Zealand Stock Exchange (NZX) listed companies over 2000 to 2007 (inclusive), this paper finds evidence consistent with the hypothesis that non mandatory nature of corporate governance regulation enhances better board committee practice. Extant research on board committee suggest strong market monitoring and regulated environment of management increase higher compliance. However, this study evidenced that non mandatory regulation enhances higher compliance of board committee.

The paper proceeds as follows: section 2 and 3 review the New Zealand regulatory framework for board committee and literature respectively and provides theoretical framework of hypothesis in section 4. Sample distribution and variables measures were explained in the section 5. Section 6 explained the results followed by conclusion and recommendation of this research.

2. Regulatory framework of supervisory committees in New Zealand

Corporate governance regulations were started implemented early this century in New Zealand immediately following corporate collapse in the USA, Europe and Australia. However, the corporate governance practice was in place before implementation of corporate governance regulation. Most of the countries reformed corporate governance regulation following corporate collapse in early in this decade. Sarbanes Oxley Act 2002 is one of the pioneer corporate governance regulations which set a standard of new corporate governance mechanism. New Zealand established similar sort of regulation following global trend of implementation. However, it was criticise by practitioners and academicians to implement new regulation from the beginning. New Zealand corporate sector is less regulated in compared to USA and UK, manager's accountability is flexible in compare to other countries.

New Zealand corporate governance practice was followed by the below mentioned regulations:

a. Corporate Governance Best Practice Code 2003;
b. Guidelines and Principles of New Zealand Corporate Governance 2004;
c. NZX Listing Rules.

New Zealand regulatory framework for board committees is as follows in brief:

Table 1: Board Committee framework in New Zealand

Characteristics	Audit Committee	Remuneration Committee	Nomination Committee
Committee Size	*Not mentioned*	*Not mentioned*	*Not mentioned*
Independence	*All the committee members should be independent director*	*Not mentioned*	*Majority of committee members should be independent director*
Qualification	*At least one member should be qualified accountant*	*Not mentioned*	*Not mentioned*
Responsibility	*Requires written charter mentioning duties and responsibilities*	*Requires written charter mentioning duties and responsibilities*	*Requires written charter mentioning duties and responsibilities*

3. Literature Review

The classical problem between management and ownership rise to the involvement of corporate governance (Jensen, 1993; Jensen, 1983; Jensen, 1976; Jensen, 1983; Jensen, 1993; Jensen, 1976). Giant corporate collapse over the world leads the attention to rethink on corporate governance mechanism at the end and early this century. Growing the practice of board committee becomes more remarkable recently following recent corporate collapse (Kirkbride, 2004; LaPorta, 1997; La-Porta, 1998). Establishment of board supervisory committee indicates the effective internal control mechanism. However, it is possible to set up an ineffectual committee to give impression of doing something. Arguably, if the committee composed with significant independent director, and the name published in the annual report, it is expected that the committee will operate independent and effectively.

Firm surviving in the competitive environment indicates optimal level of corporate governance compliance. Firms that fail to adapt their governance structure to change in the business environment supposedly face extinction (Kole, 1997). They argued deregulation increase the importance of management. The principle based regulation or non-mandatory types of regulation increased the importance of management in New Zealand. Moreover, ownership concentration increases after deregulation to encourage higher monitoring of management by the shareholders.

Corporate governance research has been criticised for over emphasizing on board of director composition (Goldfinch, 2004). However, board committee research is very insignificant in recent literature. Formation of audit committee and determinants are well established research (Chandler, 1982). Nomination committee and remuneration committee formation and determinants are not well examined from the perspective of regulatory compliance. The formation audit committee was the crucial start of board committee formation on early last century, mostly after Sarbanes Oxley Act (SOX) in USA. A series of corporate collapse raised questions against effective corporate governance and formation of board committees is the best consequence to solve inside control mechanism (Ahmed, 2006).

Board role and composition of board role is inter-related. Existence of board committee is dependent on board independence (Berghe, 2004). A significant literature suggests that independence of board increases more accountability and better internal control mechanism in the firm. Independent board members are free of personal interest and focused on career therefore the activities are free of biased. However, literature argues that none of the board members are independent due to selection process. Selected board members are thankful to the nomination committee and slack of independence. Moreover, CEO plays a significant role on board committee formation (Hermalin, 1988).

More busy board becomes less effective in internal control systems because of less commitment on specific firm (Brennan, 2004; Brown, 2006; Brown, 2004; Brown, 2004; Brown, 2006). Board busyness reflects outside directorship in addition of one company position. Literature posits that busy director may not provide quality time either regular directorial activities or supervisory committees. Moreover, Effective board mostly defined as frequent director meeting firms and therefore higher frequency of meeting raised significantly more issues to solve (Canavan, 2004; Carson, 2002). Supervisory committees are dedicated to take care of specific issues in addition of board of directors. Even thought the supervisory committee is comprised of board members, dedicated committees are more effective rather than regular board.

CEO duality creates lack of independence of board and supervisory committees. Same person holding two positions creates role conflicts too. Organizational theory suggest that autocratic behaviour reduces the motivation of management therefore the board chairman and CEO must be separate to balance of duty, responsibility and power. Firm audited by Big-4 firms indicates higher accountability. Big audit firms are more independent and implement significant standard audit judgement to the client therefore practice of board committee is expected. Audit firms also suggest better practice to the clients in addition of auditor services.

Existence of audit committee, remuneration and nomination committee increase higher financial accounting disclosure, better reporting practice which reduces managerial discretion and increase earnings quality (Carson, 2002). Literature evidences that existence of independent and effective board can ensures higher reporting practice. In the same vein, supervisory committee also depends on composition and effectiveness of board.

4. Theoretical framework of Board Committees in New Zealand

The corporate structure of New Zealand is different in compare of other first world countries. The ownership concentration in New Zealand is higher in compare to the USA, UK and Australia. Stock market crash in 1987 causes a significant damage of investors' confidence and there after firms started to get more privatised but ownership concentration is significantly higher. Moreover, Stock market is moderately strong to implement security and exchange commission's rules.

Most of corporate governance regulation is 'best practice code' which seeks 'best practice' irrespective of the business nature (Fasterling, 2005). New Zealand corporate governance regulations are also non-mandatory 'soft regulation' which promotes best use of the provisions. This implies no compliance of non-mandatory codes will be revised according to the market suitability as one code may not apply for all sectors. However, the code is accepted to most of the existing firms then non-compliance firm will feel pressure to comply due to retain investor's confidence.

Regulation and corporate governance has become important issue of research to the social scientist after a series of corporate collapse (Romano, 2005; Aguilera, 2004; Bicksler, 2008). Following a flow of corporate governance regulation, determine the effectiveness becomes more important after a decade of regulation. Most of the corporate governance was issued early of this century and non-mandatory in nature. Corporate governance was voluntary before that regulatory implication, where firms had the freedom to practice certain norms of corporate governance. But, non-mandatory regulation reduces the freedom by corporate governance codes, principles and guidelines; mostly called 'soft regulation'. Those regulations are well supported by securities exchange commission and stock exchange in the respective economy. Similarly, corporate governance best practice code 2003 is a benchmark for newly listed companies in NZX.

New Zealand business sector is mostly in concentrated ownership with regulatory influence which is principle based. Unlike rule based economy such as the USA, New Zealand has flexibility on corporate governance compliance. The directors are more independent and less accountable to the shareholders which raised the question of independent director effectiveness. SOX allow penalty and imprisonment for director due to intentional wrong forecast or even fraudulent financial statement. Due to the flexibility of director, formation of board committee may not seem usual practice. Moreover, non-mandatory regulation allows 'comply or explain' type of compliance where firms may not comply but to explain.

The flexibility of director role and regulation both, compliance of board committee may not possible in concentrated ownership environment. Literature posits mixed evidence on corporate governance regulation whereas regulation matters irrespective of nature. Arguably, non-mandatory regulation ensures 'tick-the-box' tendency of corporate governance compliance. Moreover, common corporate governance code does not fit for all sectors is another common argument against governance regulation (Davies & Schlitzer, 2008; Faleye, 2007).

In New Zealand, the change in regulatory philosophy emphasize increased board independence (one-third minimum), as well a reduction of informational asymmetry through the transparent corporate governance regulation. An audit committee with fully independent director will ensure better accountable internal control mechanism. However, majority independent of nomination committee but silent on remuneration committee raised the question on effective corporate governance too. Nonetheless, an expert committee member is a must for audit committee but silent on remuneration and nomination committee. Moreover, it is expected that the regulatory influence will impact positive on board role and compliance of board committee formation.

5. Research Design

This section describes the research design in the following two subsections. Firstly, the total sample selection processes were discussed and finally, all the variables were described as follows:

5.1 Sample Selection

New Zealand stock market (NZX) is composed of two main categories: New Zealand Stock Exchange (NZSX) which includes relatively established companies during the time period and listed for long and New Zealand Alternative Exchange (NZAX) companies are relatively new and fast growing with more demand of market capital. Generally NZAX companies are allowed to raise capital with lower cost from NZX. NZX was listed with 123 companies as at April 2008 and among those 26 companies were excluded due to financial nature of business as they needs to follow different types of regulations. Further, 27 companies were deducted due to unavailable set of data. The sample consists of 560 firm year observations based on NZX listed firm with required data for all the tested variables. Corporate governance variables were manually collected from the annual reports of the sample companies from Investment Research Group (IRG) database. Other required financial statement data extracted from DATASTREAM and was supplemented by annual reports. Followings are the list of industrial category according to NZX classification:

Table 2: Industry classification of sample

Industry	**Sample**
Agriculture & Fishing	*5*
Building Material & construction	*2*
Consumer	*15*
Energy	*8*
Food & Beverage	*2*
Forestry & Forest Product	*1*
Intermediates & Durables	*8*
Investment	*5*
Leisure & Tourism	*4*
Mining	*1*
Port	*4*
Property	*5*
Telecommunication	*4*
Transport	*6*
Total	**70**

5.2 Mode and Variables Measurement

The fundamental model tested is:

$$
\begin{aligned}
BCTOT_t = {} & \theta_0 + \theta_1 bodsize_t + \theta_2 bodind_t + \theta_3 bodbus_t + \theta_4 bodmeet_t + \theta_5 CEOdual_t \\
& + \theta_6 Big-4_t + \theta_7 mgtsh_t r + \theta_8 cntlshr_t + \theta_9 bussten_t + \theta_{10} totalass_t \\
& + \theta_{11} leverage_t + \theta_{12} regulation_t + \theta_{13} ROA_t + \varepsilon_t \; \ldots \ldots \ldots (1)
\end{aligned}
$$

Where,
Bodsize = board size of firm, measured by total board member;
bodind = board independence measured by board of director independence ratio;
bodbus =board of director business, measured by outside involvement of board;
bodmeet =board meeting measured by board of director meeting frequency;

CEOdual = CEO duality, firms operating with CEO duality valued as 0 and 1 otherwise;
Big-4 = Big-4 audit firm, firms audited by big-4 auditor valued 1 and 0 otherwise;
Mgtshr = management shareholdings percentage;
Cntlshr = control shareholdings, individual shareholding with more than 50% in a single firm year valued 1and 0 otherwise;
Bussten = firm operating tenure in years;
Totalass = total assets of firm as a proxy of firm size;
Leverage = leverage of firm as a proxy of risk;
Regulation = a dummy variable of regulation;
ROA = return on assets.

Our primary coefficient of interest is coefficient of regulation (θ_{12}). If the board composition, external auditor and ownership concentration is significant then firm trends to establish board committee. The effect is expected to be more pronounced after the regulation is effective then it is expected that formation of board supervisory committee will increase on post regulation period. Because firms are on minimum pressure as the corporate governance code, principles and guidelines settled a benchmark for all the existing companies in NZX.

6. Results

This section describes the research results for descriptive, correlation and regression analysis. Table 3 described the descriptive statistics for all the research variables. The average board committee compliance is 2.41 indicates that a number of companies are not forming all the suggested three board committees. The average board size is more than 6 directors; however, 3.83 independent directors reflect almost half of the directors are independent in the board. Even though the outside board directorship is 25.80 but the meeting frequency 7.84 times indicates that directors are more active on day to day monitoring role. CEO duality 0.90 indicates that 10% of the CEO holds dual position in the firm over sample year. Managerial shareholding of 0.17 indicates managers have more interest on firm's performance and almost 27% of the firm year was operated with control shareholdings.

Table 3: Descriptive Statistics

Variables	Mean	Std. Deviation	N
BCTOT	*2.41*	*.809*	*560*
BODSIZE	*6.23*	*1.576*	*560*
BODIND	*3.83*	*1.550*	*560*
BODBUS	*25.80*	*13.120*	*560*
BODMET	*7.84*	*2.915*	*560*
CEODUAL	*.90*	*.298*	*560*
BIG4	*.87*	*.335*	*560*
MGTSHR	*.1721*	*.38921*	*560*
CNTLSHR	*.27*	*.446*	*560*
BUSSTEN	*30.30*	*34.355*	*560*
TOTASS	*1732828.68*	*6024749.78*	*560*
LEVERAGE	*.2865*	*.33218*	*560*
REGULATION	*.5000*	*.50045*	*560*
ROA	*.0300*	*.49910*	*560*

Table 4 indicates the correlation analysis for all the variables with dependent variable. It indicates that existence of all the board committee in a single firm year is positively correlated with board size, board independence, board busyness and board meeting frequency in different significant level. However, CEO duality and management shareholding does not have statistically significant correlation with board committee formation. External auditor also has positive statistical significance with board committee formation.

Control shareholding also have negative significance indicating that firm operating under control shareholders tends to concentrate on less attentive on board committees. Other control variables like total assets shows positive significance indicating large firms comply better. However, more levered firm comply less shows risky firm's corporate governance is significantly lower. Performance proxy variable shows positive significance indicating profitable firms complied better board committee practice which enhances higher return. More importantly, regulation shows positive significant correlate with board committee formation means regulatory bindings enhances better board committee practice over the sample period.

Table 4: Correlations Analysis

Variables	BCTOT	BODSIZE	BODIND	BODBUS	BODMET	CEODUAL	BIG4	MGTSHR	CNTLSHR	BUSSTEN	TOTASS	LEVERAGE	REGULATION	ROA
BCTOT	*1.00*	*0.24****	*0.12****	*0.22****	*0.24****	*-0.04*	*0.06**	*-0.07*	*-0.16****	*0.12****	*0.19****	*-0.06**	*0.12****	*0.13****
BODSIZE		*1.00*	*0.56****	*0.49****	*0.15****	*0.04*	*0.22****	*-0.14****	*-0.08***	*0.11****	*0.36****	*0.06**	*0.07***	*0.19****
BODIND			*1.00*	*0.45****	*0.13****	*0.08***	*0.15****	*-0.14****	*-0.04*	*-0.08***	*0.31****	*0.10****	*0.06**	*0.13****
BODBUS				*1.00*	*0.32****	*0.01*	*0.25****	*-0.15****	*0.10****	*0.04*	*0.27****	*0.01*	*0.07***	*0.03*
BODMET					*1.00*	*-0.08***	*0.07***	*0.03*	*0.14****	*-0.10****	*-0.03*	*0.06*	*0.05**	*0.08***
CEODUAL						*1.00*	*0.05**	*0.01*	*-0.04*	*0.00*	*0.03*	*0.00*	*-0.05*	*-0.02*
BIG4							*1.00*	*-0.14****	*0.10****	*-0.14****	*0.10****	*0.04*	*0.04*	*0.06***
MGTSHR								*1.00*	*-0.05**	*-0.13****	*-0.11****	*-0.02*	*-0.06***	*-0.04*
CNTLSHR									*1.00*	*0.03*	*-0.09***	*-0.15****	*0.03*	*0.01*
BUSSTEN										*1.00*	*0.21****	*-0.17****	*0.06**	*0.07**
TOTASS											*1.00*	*-0.01*	*0.01*	*0.06**
LEVERAGE												*1.00*	*0.06**	*0.08***
REGULATION													*1.00*	*0.05*
ROA														*1.00*

***, **, * indicates 1%, 5%, and 10% level of significance

Table 5 shows the ordinary least square regression results of the model showed in earlier section. The entire board composition variable shows strong positive significance with board committee formation. It means board composition impact significantly of formation of corporate governance practice, specifically board committee formation. More independent board tends to establish board committee for the accountability of firm in presence of regulation in the sample period. The CEO duality have negative coefficient with board committee formation but more than 10% level of statistical significance. External auditor as big-4 firms does positive significance at more than 10% level of significance too.

Table 5: Coefficients of Model

Variables	Coefficients	t-value	VIF
(Constant)	*1.596*	*8.079 ****	-
BODSIZE	*0.057*	*2.132 ***	*0.55*
BODIND	*0.033*	*1.29**	*0.606*
BODBUS	*0.006*	*1.966 ***	*0.614*
BODMET	*0.064*	*5.484 ****	*0.846*
CEODUAL	*-0.073*	*-0.69*	*0.978*
BIG4	*0.039*	*0.39*	*0.867*
MGTSHR	*-0.08*	*-0.96*	*0.93*
CNTLSHR	*-0.384*	*-5.24 ****	*0.906*
BUSSTEN	*0.002*	*1.905 ***	*0.835*
TOTASS	*0.00*	*2.289 ***	*0.796*
LEVERAGE	*-0.254*	*-2.61 ****	*0.93*
REGULATION	*0.147*	*2.333 ***	*0.977*
ROA	*0.147*	*2.279 ***	*0.939*
Adjusted R-square	*0.18*	*Durbin-Watson*	*1.62*
F-Stat P-value	*9.87 ****	*Sample*	*560*

***, **, * indicates 1%, 5%, and 10% level of significance

Ownership concentration variable shows both negative coefficients with formation of board committee. Management shareholding shows inverse relation in compare with correlation analysis in the regression result. However, control shareholders have consistent significance with the formation of board committee. It means more ownership concentration reduced the motivation of board committee formation in the firm. Business operating tenure also has more significant positive relation with board committee formation. More importantly, regulation shows positive significance of board committee formation. Firms operating in the regulatory environment increased the possibility of better governance practice. It could results for self development or from the pressure of peer companies who complies. All other control variables are statistically significant. The predictability of model is 18% with statistically significant level. Durbin-Watson value of 1.62 means the model is free of autocorrelation problem as the value near to 2 indicates acceptable limit of autocorrelation.

7. Conclusions

Board committee formation determinant is one of the very few observable input available to the outsiders to evaluate accountable corporate governance structure. A sizable body of empirical research has found that regulatory environment is a certain determinant of corporate governance compliance and accountability of management. This paper expands the stream of research by incorporating regulation as a determinant of board committee establishment in the concentrated ownership structure and in a mix of board composition. Although corporate governance regulation is researched from the board independence, audit committee independence, audit expectation gap perspective, to the best of our knowledge, this is the first study to documents as association between corporate governance regulation and board committee formation. This study finds evidence consistent with the proposition that regulatory environment enhances higher corporate governance compliance. An additional contribution of the paper is that control shareholding reduces the motivation to form board committee as indicator of better corporate governance practice.

This research could be a milestone for board committee research in corporate governance literature evidenced on determinant of formation. However, future analysis could focus on the effectiveness of board committee with consequences including other accounting variables. Moreover, how board committee affects the quality of monitoring role could be further research perspective.

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