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The Influence of Board Size and Ethnic Diversity in Share Repurchases Policy

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ABSTRACT

This study examines the efficacy of the recent amendment in Malaysian Code on Corporate Governance 2012 in curbing the likelihood of earnings management in share repurchases policy in Malaysia. Based on 275 firm-year observations among share repurchasing firms between 2006 and 2010, we find that by frequently repurchases shares, companies are able to manage their earnings upwards. It is also found that ethnic diversity can help curb the potential misuse of managerial discretion in deciding whether to frequently repurchase shares. Our study contributes to the existing literature on board characteristics in several ways. First, it provides evidence that board diversity in terms of ethnicity can significantly affect companies' policy. We find that companies with less diverse board as measured by ethnic group are more likely to frequently embark on share repurchase to seemingly improve current earnings. Second, we find that large board size can significantly reduce the tendency of managerial opportunistic behavior. The study provides early evidence of the effectiveness of recent Malaysian Code on Corporate Governance 2012 which recommended diverse balance of board members to ensure proper monitoring role and curbing the likelihood of unwarranted managerial opportunistic behavior by unduly controlling owners.

Keywords: Board Diversity, Corporate Governance, Business Strategy
JEL Classifications: M480, M140, M190

1. INTRODUCTION

Share repurchases were meant to help companies to stabilize their share prices during a depressed global market. Malaysian companies were first allowed to repurchase their own shares after The Asian Financial Crisis 1997-1998. Companies are allowed to repurchase or buy back their own shares by properly following strict procedures as prescribed by the Companies Act, accounting guide through Technical Release and Bursa Listing Requirements (Laws of Malaysia, 1965; Bursa Malaysia, 2009; MASB, 1999). There were few companies interested in buying back their shares in the inception years, but the trend is growing. Abdul Latif (2010) finds the number of companies announcing share repurchases have amplified from only 16 companies in 1999 to 106 companies in 2005, an increase of almost 12-fold. Share repurchases, better known as share buyback in Malaysia, have always been regarded to signal an undervaluation (Hung and Chen, 2010). Companies believed that their prices are undervalued and believed that better price performance is on the way. On the contrary Abdul Latif et al. (2013) and McNally and Smith (2007) find that there is no significant difference in long-run price performance between share repurchases group and the control group regardless of different measurements used.

It is important to note that not all share repurchases are the same. Regulations and market structures could impose different implications to the types and practices of share repurchases worldwide. For example, companies in the United States and Australia have more options on the types of share repurchases method available (Bartov, 1991). Companies, depending on their needs, have the option to use either fixed tender offer, Dutch auction tender offer or open market share repurchases. In contrast, only open market share repurchases are allowed for Malaysian companies.

Studies on emerging market are still limited thus warrant further investigations. We examine whether the recent improvement in Malaysian Code on Corporate Governance 2012 regarding board diversity can help curb the potential misuse of managerial discretion in deciding whether to frequently repurchase their shares. Our study contributes to the existing literature on board characteristics in several ways. First, it provides evidence that companies can manage their earnings by frequently repurchase their own shares. Secondly, we find that board diversity can significantly affect companies' payout policy. We find that companies with less diverse board as measured by ethnic group are more likely to frequently embark on share repurchase which seemingly improved current earnings. Thirdly, we find that a larger board size can significantly reduce the tendency of managerial opportunistic behavior.

2. LITERATURE REVIEW

Previous studies on the price effect of share repurchases evidenced that there were significant positive effects on companies' price performance. Bartov (1991) finds companies earned positive abnormal earnings surrounding share repurchases announcements whilst reference Ikenberry et al. (2000) report favorable market reactions on long-run performance. On the contrary, Abdul Latif et al. (2013) do not find any significant difference in price performance following actual share repurchases in Malaysia. The study reports that in the long-run (1-3 years period) price performances are equivalently similar regardless of the method employed (CAR and buy-and-hold returns model) or the benchmark used for control companies. Likewise, McNally and Smith (2007) find that there are no abnormal returns following actual share repurchases using previously documented data.

It is argued that companies are repurchasing shares to fulfill managerial motives (Abdul Latif, 2010; Kahle, 2002; Rodriguez, 2008; Hribar et al., 2006). Based on managerial opportunism hypothesis, Hribar et al. (2006) finds evidence to support that managers can carefully plan and time repurchase activities so as to meet earnings expectations. Using 29,339 repurchase announcements during 1980-1998, the study finds substantial evidence that companies strategically manage earnings downward prior to actual share repurchases. By doing so, companies are able to buy back shares at a lower price. Later, if share prices unpredictably rise, the repurchase companies will earn abnormal gains. Likewise, Di and Marciukaityte (2015) report positive association between earnings management through discretionary accruals before share repurchases. The study argues that companies manage earnings as an attempt to smooth expected earnings. Managerial opportunism hypothesis argued that managers with significant ownership in the companies' equity would be the ultimate beneficiaries. Nonetheless, earnings management in whatever method is considered damaging if it would deliberately cause any party to suffer losses.

Farrell et al. (2014) propose that good corporate governance mechanisms are important to limit the likelihood of earnings management through share repurchase activities. The study reports strong relationships between the likelihood of earnings management and less independent board as well as the presence of CEO duality, where CEO holds both positions as the chairman of the board and as the managing director. CEO duality could prove to be damaging to companies' future performance (Taufil Mohd et al., 2016). Board diversity is one of the recommended agenda in the recent Malaysian Code on Corporate Governance 2012. Board members can be of different diversity type, including ethnicity, gender, or experience. Diversity on boardroom has gained much attention from researchers, analysts, corporations, regulators and shareholders. A survey by PricewaterhouseCoopers (2014) indicates that the demand for board diversity, whether in the form of gender or ethnic diversity is increasing. Some countries such as in the US and UK may have even requested that the company provides quotas for diversity implementation (Upadhyay and Zeng, 2014).

3. DATA AND METHODOLOGY

The impact of board characteristics on share repurchase frequencies is investigated in this study. Following Farrugia et al. (2011) share repurchase frequency is defined as the number of times a company initiates share repurchases from 2006 to 2010. The company is considered as a frequent repurchaser if it initiated at least three repurchases in the 5-year span. Sample companies were collected from all actual share repurchases undertaken by non-financial public listed companies. To ensure visibility of the results, only share repurchases exceeding 0.1% of ordinary shares outstanding were included. A total of 770 completed shares repurchases were observed in this period. Out of these, 405 observations involved share repurchases of <0.1%; thus, leaving 275 observations suitable for analysis. The following equation was estimated to examine the relationship between board characteristics and the frequency of share repurchases:

$$FREQUENCY_{it} = \beta_0 + \beta_1\, REPURCHASE_{it} + \beta_2\, BOARD_{it} + \beta_5\, CDIR_{it} + \beta_6\, FDIR_{it} + \beta_7\, CEPS_{it} + \beta_8\, LNMV_{it} + \varepsilon_{it} \quad (1)$$

FREQUENCY is a binary code which equal to 1 if the frequency of share repurchases is 3 or more in a 5-year period, otherwise it is 0. *REPURCHASE* is the total number of repurchase shares scaled by the number of outstanding ordinary shares. *BOARD* is the total number of directors. *CDIR* is the number of Chinese directors serving on the board.

CEPS is change in earnings per share (EPS), a measure of earnings management through EPS performance. It is calculated as the change of EPS minus "as if EPS." "As if EPS" is calculated assuming share repurchases had not occurred. *LNMV* is the natural log of company's market value, a measure of company size. ε is the error term.

4. RESULTS AND ANALYSIS

4.1. Descriptive Analysis

Descriptive statistics of sample companies are summarized in Table 1. On average, sample companies repurchased their own shares more than 3 times in the 5-year span. This means that

Table 1: Descriptive analysis

Variables	Mean	Median	Min	Max	Standard deviation
FREQUENCY	3.70	4.00	1.00	5.00	1.27
REPURCHASE (%)	1.7	1.0	0.1	10.0	2.0
TOTDIR	7.93	8.00	5.00	14.00	1.85
CDIR	5.43	6.00	0.00	11.00	2.26
MALAYDIR	2.16	2.00	0.00	9.00	1.63
SIZE (LNMV)	13.40	13.19	10.51	17.36	1.33
CEPS	−0.021	−0.019	−0.374	4.857	0.306

CEPS: Change in earnings per share

Table 2: Probit regression analysis using robust standard error

Variables	Expected sign	Coefficient	Robust standard error	Z value	P value
REPURCHASE	−ve	−15.950	4.755	−3.36	0.001***
BOARD	−ve	−0.205	0.059	−3.45	0.001***
CDIR	+ve	0.164	0.044	3.70	0.000***
CEPS	−ve	−2.578	1.319	−1.95	0.050**
LNMV	−ve	0.029	0.057	0.52	0.601
Constant		0.897	0.549	0.103	0.103
Observations	275	Wald Chi-square (5)	26.03	Pseudo R^2	0.0683

.*Denotes significant at 10%, 5% and 1% level using a two-tailed test. Results are equivalently similar for logit model using robust standard error. CEPS: Change in earnings per share

companies in Malaysia are frequent buyers. In contrast, companies in United States repurchase their shares infrequently, only once in 3 years (Jagannathan and Stephens, 2003). The percentage of shares repurchased is quite small with an average (median) of 1.7% (1%). This figure is lower than those in the United States and Sweden where the reported average percentage in open-market share repurchase program is about 8% and 3.5% respectively (Ridder, 2015) On average eight directors served on the board. Out of this, about six are of Chinese ethnicity (CDIR) and only two are Malays (MALAYDIR). Despite the growing appeal for diversity, the proportion of ethnic groups serving on public listed companies remained fairly unchanged. Between 65% and 69% of board members are of Chinese ethnicity while only 25% is Malays. On average the CEPS is negative 0.021 cents, which means that if companies had not repurchased their own shares, the EPS would be worse than the currently reported in EPS. Based on the above results, it could be hypothesized that companies buy back their own shares to smooth their reported EPS.

4.2. Regression Analysis

Before assessing the association between board of directors' attributes and frequency of share repurchases, correlation analysis between the independent variables is carried out. The correlation between Chinese directors (CDIR) and total directors (TOTDIR) is 0.75. However, none of the pairwise correlation is significantly higher than 0.8 suggesting that the impact of multicollinearity is not severe. Since this study employed a reasonably large sample, the normality assumption does not assume a critical role. The results suggested that frequent repurchases bought smaller volume of shares and experienced lower earnings performance measured by CEPS. The greater are the CEPS, the more frequent are the repurchases. The result suggests that managers might use share repurchases to smooth earnings. Furthermore, the results show that larger board size lead to less frequent repurchases while Chinese directors lead to more frequent repurchases. The coefficient for executive directors is negative as expected but not significant. Size of companies as measured by LNMV is not associated with frequency of share repurchases decision (Table 2).

5. CONCLUSION

The study examines whether the recent improvement in Malaysian corporate governance code regarding board diversity can help curb the potential misuse of managerial discretion in deciding whether to frequently repurchase their shares. The findings confirmed that companies frequently repurchase shares to manage reported EPS. It is evidenced that board diversity as measured by director's ethnicity is significantly associated with frequency of share repurchases. The less diverse is the board, the more likely a company will frequently embark on share repurchases. Next, the study finds that larger board size can significantly reduce the tendency of managerial opportunistic behavior. Therefore, the study provides early evidence of the efficacy of recent Malaysian Code on Corporate Governance 2012, which recommended diversity among board members to ensure proper monitoring role and curbing the likelihood of unwarranted managerial opportunistic behavior. Future study may examine whether control and power of independent and ethnic directors entail better monitoring and fiduciary duty.

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