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# The Role of Board Competencies on Voluntary Risk Disclosure of Malaysian Listed Companies

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**Abstract:** This study aims to examine the effects of board competencies as enhanced governance mechanism in enhancing transparency and accountability. A quantitative investigation is adopted to capture the extent of voluntary risk disclosure disclosed in the annual reports of 163 listed firms. This study identifies three proxies of board competencies: leaders' commitment and support as well as duality and international experience are significant in influencing management voluntary risk disclosure decisions. Competent board members can be a valuable mechanism in complementing the commitments of regulators to promote higher corporate transparency. Findings on the three characteristics of board competencies in this study provide insights on the improvements of effective board of directors.

**Key words:** Board Competency · Leader Commitment and Support · Duality · International Experience · Agency Theory · Voluntary Risk Disclosure

## INTRODUCTION

Managing business risks and uncertainties in volatile and complex market environment has become one of major concerns among market participants. It relates to how businesses deal with the occurrence of increased risks in their business operations [1-7]. These occurrences trigger various responses from standards setters and regulatory bodies which result in reforming and enhancing current regulations pertaining to capital market and corporate governance. The overall evidence in the growing literature discusses the importance of risk and uncertainty management as a basic idea in enhancing firm valuation [8-20]. An enhanced firm valuation is seen as an indicator for business survival and an important element to be assessed by shareholders and potential investors, as it indicates their initial beliefs in the ability of firms to manage the uncertainty of the business operations. Failure to provide a satisfactory firm valuation will result in increasing distrust in the ability of firms to manage uncertainty issues.

Recent literature observes an aspect in the risk management system that should be seriously considered. It dwells on the transparency and disclosure of risk and information uncertainty of business events. Inaccurate and poor interpretation of current risk reporting is expected to deter further investment decisions of the investors due to the lower valuation of the firm [21-50]. In this respect, [40] contends that in order to facilitate effective risk management systems, firms should consider practising risk reporting by providing relevant information pertaining to the management of risks and the uncertain impact on the firm's competitive advantage in the capital market. As such, the management of risks can be translated into adequate reporting that can be used to help investors understand and expect less volatility in an uncertain business environment. Driven by the need for managers to be accountable in presenting corporate reporting, this study addresses important enhancements from past literature. In view of prior empirical results of board competence that focused on past academic and professional experiences in shaping the competency of board members, recent studies suggested to relate competencies with the ability to comprehend their own judgments in managing crucial decisions [37, 51]. Second, most of prior studies in corporate governance practices among Asian countries shown the enhanced governance mechanisms which includes voluntary disclosure practices might overcome information asymmetry problem [52-60], which were conflicting with studies based on

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developing countries [52]. The fact that Malaysia has been comprehensively implemented the sound governance in many areas, the question remains as to what extent the companies transparently disclosed their strategic decisions in relation to risk information in corresponding to the shareholders' needs.

**Literature Review and Hypotheses Generation:** Agency theory, board competencies and voluntary risk disclosure The agency theory suggests several mechanisms to overcome conflicts between the principals and managers, which have been viewed as strengthening the corporate governance system. It further noted that the interaction between the manager and shareholders could cause problems in unforeseen events since both parties have their own objectives to achieve [42]. Thus, to mitigate the problem, greater disclosure of public information is recommended to provide better assessment of directors' decision making towards improving firm valuation [18, 24, 31]. As such, an accountable director should be able to cautiously oversee routine as well the occasional events, so that any decisions taken would be in parallel with shareholders' expectation. Apparently, the ability of making the right decisions for erratic issues would only be acquired through cycles of experiences, that later being acknowledged as possessing characters of competent leaders [14]. A competence person would be someone with the ability to consider possible factors with own judgements when evaluating issues and giving feedbacks in flexible ways [37]. Other plausible indication of competent person would be someone or a group of person who are committed to inspire others in executing the decisions made earlier, apart from their functional tasks and experiences. It is being contended that the terms of leadership and competencies are somehow interrelated, where competencies being elaborated in discussing leadership domain [14]. Further in recent literatures, the competencies are linking to ability to anticipate dynamic strategies in a changing environment [15, 17]. The mixture of substantive competencies possessed by the board of directors is essential to ensure all important steps that have been considered in corporate strategic decisions including the consequences of those decisions [9].

**Directors' Commitment and Support:** Full commitment and support from the board of directors are important to ensure the strategic decisions are achievable. Notwithstanding, the directors' capabilities and competencies that are gained throughout their life and work experience are equally important in getting full devoted team [19, 29]. As such, a committed and supportive director is seen as important to fulfil the firm's profit-objective, which is certainly influenced by several factors including vast knowledge in business matters, professional skills and prior working experience that would demonstrate in momentous influence towards better effective board monitoring [48]. An indication of effective board monitoring is reflected in the capabilities of the directors in determining precisely which type of information is appropriate to be disclosed to the public [13]. As the public disclosure strategy has been seen as effective medium of communication, it is presumed that the information disclosed both mandatory and voluntary would be able to build trusts and confidences among shareholders and potential investors. The selection of information which had to be prudently identified and analysed would be a sign of involvement of skilful members of the board as well the top management [20]. To derive such outcome, the enhancement of knowledge, supporting skills and competencies of managers are utmost required in a competitive environment [30]. In other word, [20] suggest the top management should clearly demonstrate their actions that would create visibility and awareness in any corporate communications either through internal or external channels. This, in turn, reflects strong support of the managers, especially the CEOs, in any improvement efforts towards maintaining firm transparency and sustainability. To exert effective firm strategies, CEOs need to show their strong support through embarking on committed communications in either written or verbal form, to show their continuous response to internal and external economic environments that could influence their strategic decisions [5, 12].

Being the most influential person in the firm, a CEO could exert his or her power to influence board decisions on the amount of voluntary risk information that should be allowed to circulate. They may intend to portray their prescribed actions by showing their full support and commitment towards greater voluntary risk information disclosure as these decisions would be the way to align the interests of the shareholders, maximise their wealth as well as to protect their own job security and benefits. Thus, this study argues that high commitment and support from the board of directors on firms' strategic decisions have the potential to influence greater management decisions on voluntary risk disclosure. Therefore, from the argument put forth, hypotheses are formulated as follows:

**H1:** Directors' commitment on corporate strategic decisions is significantly positively related to the quantity voluntary risk information disclosure.

**Duality Roles:** Duality roles can be interpreted as the situation where a person who has been appointed as a Chairman of the firm is also appointed as the CEO of the same firm [56]. Holding dual positions as the Chairman and the CEO would certainly provoke a number of conflicts of interests [27] further bringing to the surface a question about the independence of management judgement on the overall business strategic decisions [21]. Furthermore, another concern in respect of CEO duality lies in the effectiveness of the board's decisions on the business, especially when dealing with risky options in corporate business events and investment choices [23, 43].

Prior studies indicate a negative relationship between CEO duality and greater voluntary disclosure [2, 57]. Further, [2] indicate the negative impact of CEO duality is found on the voluntary disclosure in Italy, whereby the low level of disclosure is observed due to increasing information asymmetry. Therefore, a person who holds both functions may expect to exert more managerial than monitoring functions, which may withhold unfavourable information to outsiders. In addition, a large number of empirical studies provide evidence of no relationship between these two elements [4, 24]. This separation is to provide the essential checks and balances over management performance, which is in line with the agency theory whereby less information would hinder close monitoring by different persons as a way to reduce conflict of interests. In light of the above, much concern has been expressed concerning the need to have thorough judgement of management and effective monitoring by the board of directors to contribute to effective risk management in an uncertain environment [10, 28, 55]. Thus, this study expects a lower quality of voluntary risk disclosure with the presence of dual CEO-Chairman roles. Therefore, the following hypotheses are formulated:

**H2:** The presence of CEO-Chairman duality roles is significantly negatively related to the quantity voluntary risk information disclosure.

**International Experience:** Invaluable experience that has been obtained from the academic side and the functional career tracks would determine the preferences and styles of the leaders in disclosing or withholding certain information voluntarily [8, 25]. In a complex business environment, international experience in foreign and local markets enables the board members to provide constructive comparisons between opportunities and problems when they have to resolve major problems [44]. Furthermore, prior research in an international setting has noted the value of international experience possessed by the firm leader/executive. This is a matter of acquiring tacit knowledge about the awareness and adaptation phase to the local market that may include competition, cultural norms, common practices and regulations [9, 44]. Experience in industrial practice can be gained through professional training and development and they help managers in interpreting and applying accounting requirements in a consistent manner, thus shaping the manager's discretion in disclosing voluntary information relating to standard requirements.

Several prior studies have observed the positive association between the determinant of qualified management members and the level of firm disclosure [6, 16]. This implies the need to have managers' discretion in determining whether the information to be disclosed to the public is good or bad. This argument is consistent with that of [33] who expect that managers with accounting and business academic backgrounds may choose to disclose more timely information to improve corporate image and portray management team credibility. Similar to the point made by [41], it is revealed that the expertise of board members gained from past experience may avoid ambiguous decisions, which is reflected in high quality reporting. In other words, the more board members with financial expertise, the greater the voluntary disclosure expected. In addition, [38] note that the managers are likely to make decisions concerning firm strategy based on their past experience when tasks become more complex and it is getting more and more difficult to avoid the impairment of their rational and optimal decisions. What is more, adequate international experience gives directors confidence in estimating the potential risks and returns associated with firm strategy [35]. Therefore, they are expected to be more committed in their involvement in the firm's strategic decisions and this, in effect, influences the voluntary risk disclosure in the annual reports. Based on the above arguments, the following hypotheses are developed:

**H3:** The high percentage of the international experienced directors is positively significant associated to the quantity voluntary disclosure of risk information

## Methodology

**Sample and Data Collection:** The sample was drawn from non-financial companies listed on the main Board of Bursa Malaysia for the financial year of 2009. The financial year end 2009 is selected as it represents the latest year end during the period of the study. The selected companies represent nine sectors, namely Consumer Product, Industrial Product, Construction, Infrastructure project, Trading and Services, Technology, Properties, Hotel and Plantation. They are selected from six industries, namely construction, consumer products, industrial products, plantation, property and trading/services industries.

The research approach involves the content analysis of listed companies' published annual reports. Content analysis has been adopted in most of the prior research as it could capture the extent and volume of disclosure information, which is mainly reported in narrative statements with a quantitative nature [22, 45] and it also applies to corporate risk disclosure studies [1, 3, 47]. In addition to the identified independent variables, this study includes the size of an organisation and leverage as control variables [26, 47]. The definitions and measurements of variables used in this study are listed in Table 1.

**Quantity of Voluntary Risk Disclosure:** To measure the extent of voluntary disclosure of risk information, the sentences containing risk-related words are counted, as risk information is only meaningful when it refers to the whole meaning of the sentence [46] rather than counting the word as it might not have any meaning without referencing to the sentences and its context [49]. To avoid subjective judgment and inconsistency in computing the extent of voluntary disclosure [50, 60], specific keywords are pre-defined, which are counted using Microsoft Word. Therefore, all images such as charts, diagrams, pictures and captions were also excluded from the analysis to minimise the amount of subjectivity involved.

Following [1] and based on the [39], two ways are used to capture the keywords of risk. First, sentences containing the keyword "risk" are identified and highlighted, while ignoring the sentences if no "risk" term appears. However, according to [39] risk information needs to be considered not only by downside risks but also by the upside or the opportunity occurrences of the risks. Risk information contained in sentences or paragraphs may not be directly expressed using the specific word or term of "risk".

Therefore, in order to thoroughly quantify the keyword of risk, the second method is to capture risks in three contexts -variation, uncertainty and opportunity. [1] describes risk as a variation that could include the following keywords: fluctuation, volatility, oscillation and amplitude. For risk such as uncertainty includes unexpected, contingency, surprise and shock. For risk such as opportunity includes prospect, potential, upside and advantage. These keywords are identified using a computer-based approach and the frequency that each keyword appears is counted. All keywords are identified and counted in narrative statements contained in several sections, such as the Chairman's Statement, the Review of Operations, the Statement of Corporate Governance, the Statement of Internal Control and the Statement of Risk Management. Annual reports are viewed through portable document format (PDF) and details of the keywords are listed below. Paragraphs and sentences that contain risk factor keywords are then transferred to Microsoft Word files and labelled by specific company name and industry classification.

## Analysis and Results

**Descriptive Statistics:** Table 2 presents the descriptive statistics on the dependent variable, QTVRD. The results of the descriptive statistics for continuous independent variables and control variables are presented in Table 3.

Table 1: Definition and Measurement of Variables

| Variable Acronym | Definition | Measurement |
|---|---|---|
| QTVRD | Quantity of voluntary risk disclosure | Content analysis of annual reports, using keyword count as a unit of analysis. |
| LCOM | Leaders Support Commitment | Dichotomous score of 1 if there is additional Risk Management section being reported; 0 if otherwise |
| LDUAL | Leaders Duality | Dichotomous score of 1 if the Chairman is also a CEO of the company; 0 if otherwise |
| LEXP | Leaders Experience | Dichotomous score of 1 if the Chairman/CEO of the company has international experiences either from academic or career; 0 if otherwise |
| LEV | Leverage | Total debt divided by total assets |
| SIZE | Size of the company | Total assets |

Table 2: Descriptive Statistics of Quantity Voluntary Risk Disclosure measured by Keywords

| | N | Min | Max | Mean | % change in mean | Std. Dev |
|---|---|---|---|---|---|---|
| QTVRD | 163 | 2.00 | 325 | 25.21 | 3.83 | 39.799 |

Table 3: Descriptive Statistics of Continuous Independent and Control Variables

| Variable | Minimum | Maximum | Mean | Std. Deviation |
|---|---|---|---|---|
| LCOM (%) | 0.00 | 1.00 | 0.0798 | 0.2718 |
| LDUAL (%) | 0.00 | 1.00 | 0.1288 | 0.3361 |
| LEXP (%) | 0.00 | 1.00 | 0.6748 | 0.4698 |
| SIZE (RM) | 81228.00 | 43407000.00 | 2176872.9390 | 5216226.2150 |
| LEV (%) | 0.00 | 2526.65 | 78.8350 | 206.9442 |

Results in Table 2 reported that the mean value for QTVRD is 25.25 sentences that contain pre-identified keywords as explained earlier. The minimum value is 2 sentences, while the maximum value is 325 sentences. This indicates that very few companies in the sample are disclosing more extensive voluntary risk information in their annual reports.

Table 3 reported that the mean values for LCOM is 7.98%, LDUAL is 12.88% and LEXP is 67.48% respectively. This indicates that a large proportion of the board members have international experience. In relation to the control variables, the mean value for SIZE is RM2.17 million, while the mean value of LEV is 78.84 percent.

**Multivariate Analysis:** In this study, linear multiple regression is used as the basis of analysis for testing H1 to H3. The hypothesized relationships are modelled as follows.

$$QTVRD = \beta_0 + \beta_1 LCOM + \beta_2 DUAL + \beta_3 LEXP + \beta_4 SIZE + \beta_5 LEV + \varepsilon$$

where variable definitions are given in Table 1.

In the above regression model, multicollinearity was tested using the variance inflation factor and tolerance levels and found to be well within the satisfactory range. The results of the regression analysis are presented in Table 3 and are now discussed in terms of tests of each of the hypotheses established in this study.

Hypotheses H1 predicts that the commitment and support (LCOM) from the directors of the firms is positively significantly related to the quantity of voluntary risk disclosure. The results in Table 4 reveals that LCOM is significantly positive at the 1% level. Hence, H1 is accepted. This finding indicates that directors' commitment and support are at paramount in enhancing the extent of risk information in annual reports.

Table 4: Multiple Regression Results for the Effects of Board Competency on the Quantity of Voluntary Risk Disclosure

| DV: Quantity of Voluntary Risk Disclosure | | | |
|---|---|---|---|
| $R^2$ | | | 0.437 |
| Change in $R^2$ | | | 0.178 |
| Adjusted $R^2$ | | | 0.391 |
| Sig. F change | | | 0.000 |
| F | | | 9.684 |
| Model Sig. | | | 0.000 |
| | β | t | Sig. |
| Constant | 15.276 | 1.548 | 0.124 |
| LCOM(H1) | 42.381 | 4.272 | 0.000*** |
| LDUAL (H2) | -3.407 | -0.458 | 0.647 |
| LEXP (H3) | -0.115 | -0.021 | 0.983 |
| SIZE | 9.321 | 2.766 | 0.006*** |
| LEV | 2.704 | 0.971 | 0.333 |

Directors may have multiple goals during their tenure periods thus by exerting their power and control through full commitment and support towards strategic decisions have been proven in the accomplishment of corporate aims among established firms.

Hypotheses H2 expects the presence of Chairman-CEO dual roles would negatively significantly relate to the quantity of voluntary risk disclosure. Even though the results indicate negative sign for this relationship, Chairman-CEO duality is insignificantly related to voluntary risk disclosure. Hence H2 is rejected. The findings are consistent with [36], who contend that the insignificant influence of CEO duality of Hong Kong firms on the board disclosure decisions might be due to easy accessibility to voluntary information since he/she is also the substantial shareholder of the firm, thus he/she does not mind if the two jobs are, or are not, separated. This possible explanation is closely related to the Malaysian capital market environment in which being represented by firms with highly concentrated ownership indicates that substantial shareholders may also be appointed as the management team (appointed as the Chairman or CEO) to safeguard their investment.

Hypotheses H3 posits that board members with international experience are positively significantly related to the quantity of voluntary risk disclosure. The results in Table 3 reports insignificant impact on this hypothesised relationship. Hence, H3 is rejected. This suggests that the functional working experience and academic qualification acquired by the leaders were not a main factor of enhanced voluntary risk disclosure. Therefore, the level of experience and qualifications should not be taken as a distinctive point in hiring managers unless firms decide to diversify their operations internationally. The results are inconsistent with prior results that reveal the exposure to various environments in their career tracks might be advantageous to the leaders as they might only take a short time to adapt to different industry and market environments [41]. The possible explanation for these insignificant results might relate to the contention that in deciding the best alternative for critical decisions, managers could not solely rely on their past experience and be expected to use their immediate response and rational judgment [32]. In particular, it could be a plus point to those with specific experience in risk management and risk analysis as the use of such experience might promote more disclosure of risk information [11].

## CONCLUSION

This study provides insights into the importance of board competencies influencing directors' incentive of voluntary risk disclosure. The findings reveal that only directors' commitment and support has a significant influence on the extent of voluntary risk disclosure. This can be a signal to regulators to undertake more effective initiatives to encourage self-evaluation among firms by practising good corporate governance particularly through voluntary disclosure. This study also recommends further insights on in respect of the formation of effective boards of directors which should be well-blended with the inclusion of those with financial background. Fourth, in a similar context, this study suggests that the professional bodies focusing more on building relevant competencies of board members, as some prior indicators of competencies indicate insignificant results influencing corporate disclosure policy. An extensive guideline, a competencies rating and long-life learning programmes should be encouraged among managers and professionals so that the risk-related exposure and knowledge can be applied in the volatile market environment. This is parallel to the commitments of regulators in promoting higher corporate transparency throughout the corporate environment.

This study is limited with regard to the variable measurement of the leaders' commitment and support as it is based on the availability of the separate risk management report in the annual report. This study assumes that the CEO/Chairman is committed to support the corporate practices of disclosing voluntary risk information through the implementation of a risk management system that is reflected in the voluntary report. This was done based on prior research that contended that the commitment and support from top management can be visualised through the corporate vision and mission and the execution of approved strategies. Hence, the actual commitment of the CEO/Chairman is probably not really accurate, since no interviews were conducted to support this assumption. Future research may take this into consideration.

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