The Relationship between Corporate Independence and Firm Performance: The Case of Public Listed Firms in Malaysia

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Abstract

This paper examines the relationship between board independence and firm performance in Malaysia. The Malaysian Code of Corporate Governance states that at least one third of board members must be independent. Hence, this evolves the question of whether increased board independence can contribute to better performance. This study proves that those corporations which have more independent board members(more than one third of board members which is obligatory)have better firm performance. We included randomly selected 120 public listed companies in Malaysia' Stock Exchange Board (KLSE), where the performance is measured for the financial year 2006. While this work has been successfully established this positive relationship, it acknowledges the fact, that there are shortcomings. They include only three independent variables, such as independent board members, board size and firm size. Furthermore, the study is only done for one year, and it only involves 120 companies. Although the number of companies is enough to represent corporate Malaysia, a larger sample size will provide better justification for the empirical findings. Considered all these facts, we can provide strong evidence and conclude that a higher number of independent board members may significantly lead to higher business performance.

*Keywords: Malaysia, Corporate Governance, Board Independence, Firm Performanc*e

Introduction

The Malaysian Code of Corporate Governance stipulates that at least one third of any Board of Directors must consist of independent directors. The code was adopted in response to the East Asian financial crisis in 1997, calling for, among others, greater transparency and good governance.

The positive effect of this former crisis in improving corporate governance practices was summarised by the then Second Finance Minister, Mustapa Mohamad. In his own words:

The East Asian crisis poses a multitude of challenges. The biggest challenge ahead for the country is to resume its drive towards development, to resume growth. In restoring growth, an industrialising nation such as Malaysia, must have a clear process in place. This process includes sound regulation of markets, including good corporate governance practices which will aid to bring about greater depth and resilience to the Malaysian economy. What I would classify as a positive feature of the crisis, is the sense of urgency with which issues of corporate governance are being addressed. Throughout the world, corporate governance reforms have arisen from local crises. East Asia is not different. (Treasury, 199).

Mustapa was also quick not to conclude that better corporate governance practices as the silver bullet, while at the same acknowledged its importance.

This research however, focuses only one aspect of the Malaysian Code of Corporate Governance, the independence of the board of directors and its relation to the firm performance.

LITERATURE REVIEW

Does Firm Composition Affect the Firm Performance?

This chapter discusses the literature on how board composition affects firm performance or vice versa. Studies of the effect of board composition on firm performance generally adopt one of two approaches. The first approach involves studying how board composition affects the board's behaviour on discrete tasks, such as replacing the CEO, or acquiring another firm and the like. Conversely, the second approach directly examines the relationship between board composition and firm performance in which in our study has grasped its major concern. Overall correlation between board composition and firm performance involves studying whether board composition affects

overall firm performance. This approach allows us to examine the "bottom line number" of firm performance, but involves much less traceable data. Firm performance must be measured over a long periods which means that performance measures are not valid and perhaps misspecified.

Clearly, prior research does not support a clear correlation between board independence and firm performance. For example, early work by Vance (1964) reports a positive correlation between the proportion of inside directors and a number of performance measures. Baysinger and Butler (1985), Hermalin and Weisbach (1988), and MacAvoy (1983) and coauthors all report no significant same year correlation between board composition and various measures of corporate performance. A large-sample study by Ferris and his coauthors finds no significant correlation between proportion of outside directors in 1995 and ratio of market value to book value in 1997. An early expectation to these non-results come from Baysinger and Butler (1985), who report that the proportion of the independent directors in 1970 correlates with 1980 industry-adjusted return on equity. However, their ten-year lag period is very long for any effects of board composition on performance to persist. Studies in Australia, Singapore, and the United Kingdom find no correlation between board composition and firm performance either.

On the contrary, a few studies offer hints that firms with a high percentage of independent directors may perform worse. Yermack (1996) reports a significant negative correlation between the proportion of independent directors and contemporaneous Tobin's q (ratio of the market value of a firm's asset to the book value of its assets), but no significant correlation for several other performance variables (sales/assets; operating income/assets; operating income/sales). Agrawal and Knoeber (1996) report a negative correlation between the proportion of outside directors and Tobin's q. Klein reports a significant negative correlation between a measure of change in market value of equity and proportion of independent directors, but insignificant results for return on assets and stock market returns. Fosberg (1988) reports that majority-outside boards have a significantly lower sales/assets ratio, but finds insignificant (although generally negative) results for several other performance measures.

Even studies like Rosenstein and Wyatt find that stock prices increase by about 0.2% on average when a company appoints an additional outside director. This increment, while statistically significant, is economically small and could reflect signaling effects. Appointing an additional outside director could signal that a company plans to address its business problems, even if board composition doesn't affect the company's ability to address these problems. Moreover, Rosenstein and Wyatt find a stronger price reaction for outside directors who work for financial institutions than for directors whose

principal job is with another unrelated non-financial corporation. Yet, outside directors who work for financial institutions are usually treated as affiliated outside directors rather than independent directors, because their own firm may be interested in business dealings with the firm on whose board they sit. Rosenstein and Wyatt find that stock prices neither increase nor decrease on average when an insider is added to the board.

Composition of board committees

Klein (YEAR) finds that inside director representation on a board's investment committee correlates with improved firm performance. She finds little evidence that the "monitoring" committees that are usually dominated by independent directors - the audit, compensation, and monitoring committees- may affect performance, regardless of how they are staffed.

Does Firm Performance Affect Board Composition?

An important issue in studying the correlation between board composition and firm performance is the direction of causation. Board composition could affect firm performance, but firm performance can also cause the firm to change its board composition. Prior researchers have found limited evidence of an endogenous relationship between firm performance and board composition in which performance affects board composition.

Hermalin and Weisbach (1988), and Weisbach (1988), report that the proportion of independent directors on large firm boards increase when a company has performed poorly. This effect is statistically significant, but numerically small. Weisbach concludes from this evidence that since the change in board composition following poor performance is relatively small, and board composition changes very slowly over time, it is unlikely that the potential endogeneity of the board composition is a serious problem.

In contrast to Hermalin and Weisbach (1988), Klein (1998) finds no evidence that performance affects board composition. In her sample, firms in the bottom quintile for 1991 stock price returns are no more likely to add independent directors in 1992 and 1993 than the firms in the top quintile. Denis ad Sarin (1989) report that firms that substantially increase their proportion of independent directors had above-average stock price returns in the previous year. They also report that average board composition for a group of firm changes slowly over time and that board composition tends to regress to the mean, with firms that have a high (low) proportion of independent directors reducing (increasing) this percentage over time.

Why Board Composition has become a Hot Issue in Malaysia?

The year 1997 witnessed the worst financial crisis to hit the developing world since the 1982 Latin American debt crisis and prior to the still prevailing global crisis 2008/2009. What started out as a localised currency crisis in Thailand, rapidly turned into a financial and economic crisis in nearly all East Asian countries. Some parallels compared with the current crisis can be allocated. From being one of the best performing regions in the world, even up to as late as May 1997, the region became one that required the largest financial rescue in history at this time. The speed at which the crisis spread and the severity of the contagion effects were never experienced before.

As we are grappling with the most severe crisis ever these days, there is still no international consensus on the causes surrounding this previous financial crisis. The economies of the East Asian countries contracted in 1998 as a result of the crisis. Adverse developments unfurled, and the economic outlook was changed from positive to very negative. The expectations of both foreign and domestic investors changed abruptly. The region was perceived as one beset with high risks prompting a massive reversal of capital flows from the region. This resulted in the financial panic, irrational investor's behaviour, and overreaction to the changed economic and financial situation. Malaysia was not spared from the crisis: The Malaysian Ringgit experienced waves of speculative pressure. It depreciated 40% against the US Dollar by the end of August 1998 from its level in June 1997. The Kuala Lumpur Stock Exchange (KLSE) Composite Index fell by 79% from a high of 1,271 points in February 1997 to an unprecedented low of 262 points in September 1998. The vicious cycle of massive withdrawal of funds from the domestic financial markets to safer offshore havens started. The effects then spread through the banking and corporate sector. High interest rates and marked drop in domestic demand crippled the financial performance of the corporate sector. Companies borrowed heavily from banks to finance their rapid expansion during the good times, sometimes expansion to areas of non-core business. This made them very vulnerable to interest rates fluctuations. With the high interest rates and the economic contraction the debt servicing capacity of these companies were greatly affected. This in turn created large number of non-performing loans for the banking sector. As a result, banks became overly cautious in extending new loans even to viable businesses.

The financial crisis brought the weak corporate governance practices to the foreground: the weak financial structure of many companies; over-leveraging by companies; lack of transparency, disclosure and accountability; existence of a complex system of family control companies; little or no effective laws to ensure that controlling shareholders and management treat small investors fairly and equitably; assets shifting; conglomerate structures that were perceived to be given preferential treatment; allegations of cronyism – "the

aggrandizement of a politically connected few"; lack of transparency and ambiguity in the regulatory processes; and weaknesses in the credit evaluation processes by the banks. Weak corporate governance practices by these companies, though, did not cause the financial crisis, but certainly contributed to the economic crisis. Against this backdrop, the Malaysian Code of Corporate Governance (the Code) was introduced in 2000, after detailed study and recommendations made by the high level Finance Committee which was formed in 1998 with the objective of improving the corporate governance practices by the corporate sector.

2.1 Measurement Control Variables

Our regression results control for a number of factors that could affect firm performance, board composition, or both. The control variables that we use are:

- *Board size* =measured as the total number of directors on the board.
- *Firm size* = Total Assets

Dimensions & Definitions

Dimensions	**Definition**
Board Size	**Total number of directors on the board**.
Firm Size	**Proxied by log of Total Sales [log(sales)]**
Independence	**Fraction of non-executive members in the company board**

2.2 Theoretical Framework

We derived our theoretical framework based on accounting measures we draw Bhagat and Black (2002), which will be the basis of our research. Our theoretical framework includes three independent variables, which are Independence, Board Size, Firm Size. We have one dependent variable which is Firm Performance. We have developed a model in Figure 2.1 to conceptualize the conceptual framework of the study.

RESEARCH METHODS

Research Design

We follow the common practice of dividing directors into independent directors and non-independent directors. For independent directors, we further divide them into independent executive directors and independent non-executive directors. In out paper, we only consider of independent non-executive director as independent director (INDEP). We indicate the proposition of independent directors and independent executive directors as findep and findepexe.

INDEP = Findep – FindExe

The construct of our sample is sourced from downloading the audited annual report disclosed at the Malaysian stock exchange Bursa Malaysia's website (announcements.bursamalaysia.com). The data gathered for this research for the year 2006. In total, the initial list downloaded from Bursa Malaysia consists of 640 firms. The criteria for selection of samples are as followed:

- All financial institutions are excluded from the list.
- The analysis is through a balanced panel data method, any firms that do not have a 2006 data are eliminated from the list.
- All firms are assumed to be having the same financial year-end.

Data Gathering Methods

The data were gathered through the Malaysian stock exchange, Bursa Malaysia public website (www.announcements.bursamalaysia.com) and a commercial database "perfect analysis". In total, there are 640 firms listed on the exchange for the year 2006. We have randomly selected 120 firms as the sampling size for our study. All the annual reports of the selected public companies listed on the stock exchange (Mainboard, Secondboard and Mesdaq) from year 2006 are downloaded from the website.

The Population

Our research attempts to infer its result on all publicly listed company in Malaysia. The population of the result is the whole of the firms listed in the bursa Malaysia stock exchange inclusive of the Mainboard, Secondboard and Mesdaq market. All firms that fulfil the requirement of audited financial statements are included in the population. Financial institutions such as merchant banks, commercial banks, finance companies, insurance firms, brokerage houses and discount houses are excluded from the study. This is because financial institutions are subjected to different sets of rules and

regulation (Malaysia banking law) and have different motivation in their risk management practices (e.g. Bassel II).

3.1 REGRESSION ANALYSIS

As it is hypothesized that Board Independence and Firm Performance is determined simultaneously, a two-stage regression analysis is deployed. We adopted the simultaneous equation method: Two-Stage Least Squares (2SLS) to address the Endogeneity issue.

Endogeneity in board composition (Weisbach & Hermalin , 2000)

Board composition could affect future firm performance, but firm's past performance could affect the firm's future board composition. If board composition is endogeneity, OLS coefficient estimation can be biased.

Hypothesis Testing

Simultaneous two-stage regression analysis was conducted to test the hypotheses proposed in the methods section above. The results of the analyses are presented in Table 4.6. The analysis showed that the extent to which the following independent variables predicted overall firm performance: Independent 53%, and Firm Size 1%. According to the findings of the study, *Board Size did NOT have significant relationships with overall firm performance* .

Hypothesis 1

$H1_o$	There is no significant simultaneous relationship between Board Independence and Firm Performance.
$H1_A$	There is positive simultaneous relationship between Board Independence and Firm Performance.

Null hypothesis $H1_o$ is *rejected.* The results of first stage regression analysis revealed that board independent dimension is not significantly associated with firms' overall performance. However, the 2nd stage regression

revealed that board independent dimension is significantly associated with firms' overall performance.

Hypothesis 2

$H2_o$	There is no significant relationship between the Board Member Size and Firm Performance.
$H2_A$	There is significant relationship between the Board Member Size and Firm Performance.

Hypothesis $H2_A$ is *rejected!* The results of first stage regression analysis revealed that board member size dimension is not significantly associated with firms' overall performance.

Hypothesis 3

$H3_o$	There is no significant relationship between the Firm Size and Firm Performance.
$H3_A$	There is significant relationship between the Firm Size and Firm Performance.

Null hypothesis H3o is *rejected*. The results of first stage regression analysis revealed that board independent dimension is significantly associated with firms' overall performance. It accounted for 1% of the variance in students' overall satisfaction.

Discussion and Conclusion

Through this research studies, we examine a reasonably strong correlation link in between the firm performance and board independence whereby it supports a kind of conventional wisdom favouring a board with high degree of independence.

Quoted from a Malaysian context, The Finance Committee on Corporate Governance (1999) describes corporate governance as *"the process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realizing long term shareholders value, taking into account the interests of other stakeholders"*.

Daily and Dalton (2003) state that *"board independence is like a lighthouse on a dark and stormy night. It serves as the beacon of hope for corporate governance reform activists who embrace the perspective that more independent boards will results in greater oversight of corporate management and that this, in turn, will lead to improved firm performance"*

To ensure sound corporate governance, Clarke (1998) referred emphatically to the Cadbury Report's recommendations concerning non-executives directors. They should make independent judgments on issues of strategy, performances, resources, key appointments and standards of conduct. Indeed, the existence of relatively independent non-executive directors in the board will strengthen and influence decisions. In addition, it is still to be found out in how far well aligned and successful monitoring mechanisms as another potential internal catalyst factor will improve the company's performance.

However, there are still some resistance to welcome the shift from non-independent to independent members who potentially could lead to achieving better performance in the long run.

LIMITATIONS AND SUGGESTIONS FOR FUTURE RESEARCH

Due to time and budget constraint, the sample used in this research study is only limited to 120 firms within a study life span of one year (2006).

We recommend on a further study to rectify some of the weaknesses in prior works including ours by:

1. Using a large sample to improve signal-to-noise ratio.

This can be performed by examining the performance of all listed companies in Malaysia.

2. Measuring performance over a long period of time, rather than just at a single year as seen in this study.

In order to get a more representative result, it is suggested that future studies on this topic to account for the performance of firms for a period of at least five years.

3. Using a number of different performance measures.

Based on our research, only the return and asset size is measured. Other measurements that are useful in future studies include Tobin's q40, ratio of sales to assets and market adjusted stock price return.

4. Using a number of different performance measures.

Another shortcoming of this research that should be rectified is by employing a larger set of control variables, including CEO stock ownership, outside block holder ownership, independent director ownership, board size and firm size.

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