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Board Independence and Firm Performance

Sharifah Faatihah Syed Fuzi[a]* Syahrina 'Adliana Abdul Halim[a], Julizaerma M.K.[a]

[a]*Faculty of Administrative Science and Policy Studies, Universiti Teknologi MARA, 70300 Negeri Sembilan, Malaysia*

Abstract

The board of directors is a collective body that should act in the best interest of shareholders. The board requires the combination of executive and non-executive directors to pursue the shareholders' interest. The non-executive directors on the board will not be able to exercise their duties effectively, unless they are independence from management and ensure they provides unbiased business judgment. Independent directors are the person entrusted by shareholders to represent them and will help to reduce agency problems. Further, the Code of Corporate Governance and regulators recommend the composition of board members should be balanced and consist of independent directors. However, mere compliance with the recommendations is not enough if the independent directors fail to exercise their functions effectively. A study has been carried out in a few countries by examining board independence and firm performance. The results showed a mixed association between proportions of independent directors and firm performance. Although the companies comprised the highest number of independent directors, it would not assure to enhance firm performance. Thus, the existence of independent directors on board should be monitored in order to bring positive shareholder values.

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1. Introduction

At present, most organizations realize the essential roles played by the independent directors ever since the collapse of many big companies such as Enron and WorldCom. The important role of the non-executive directors is discussed in the 1992 Cadbury Report and the Tyson Report in the year 2003. The 1992 Cadbury Report has raised

* Corresponding author. Tel: +06-6342106; fax: +06-6335815
E-mail address: sfaatihah@ns.uitm.edu.my

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attention on the effectiveness of the board directors as important corporate governance mechanisms. Later, the 2003 Tyson Report focused on the requirements and development of the roles of non-executive directors who were required to possess broad and diverse knowledge, to enhance board effectiveness.

The major contribution of the board is formulating company's strategy and exercise proper oversight function throughout company operations (Zinkin, 2010). Independent directors could contribute their independent views and actively participate in board discussion. They will represent shareholders on the company's board. As independence person, they must ensure their presence and performance free from any influence of insiders or management. The company appoints independent directors to monitor the performance of executive directors and top managements. Therefore, they would pursue the interest of shareholders by maximizing shareholders' value. Zinkin (2010) has stated that several areas should be addressed by independent directors that would contribute to the effective formulation of the company strategy. They should ask questions pertaining to the businesses that the company ventures in, product market segmentation, and the valuable customers within the market segmentation (Fuzi, Rahim and Tan, 2012). Independent directors with relevant industry background and wide expertise would be more willing to challenge Chief Executive Officers (CEOs) and the management team in board discussion.

The independent directors are required by Bursa Malaysia in the composition of board member and board committees. For instance, all members of the audit committee must be non-executive directors by the majority of them are independent. These to ensure the independent directors would protect the interest of shareholders from management controlled. Malaysian Code on Corporate Governance (MCCG) 2012 has taken an effort to reinforce board independence in the company through several recommendations. The Code emphasizes on the composition of nomination committee, which should comprise of a majority of independent directors. Further, if the chairman of the company is not independent, the majority members of the board must be independence and board should review the independence of its independent directors annually. The purpose of this paper is to review some of the literatures on the board independence and firm performance which has been studied across the world. This is to testify whether the existence of independent directors on the board may lead to positive associations with firm performance.

2. Board Structure and Composition

In Malaysia, most companies are practicing the one-tier board which comprises of the non-executive directors and the executive directors. The non-executive directors are not the full-time employees as compared to the executive directors who are full-time employees and are involved in the day-to-day operation of the company. The role of the non-executive directors was as a monitoring mechanism for the performance and activities of executive directors and management. In general, the representation of non-executive directors was vital for the board's effectiveness. Therefore, the total board should consist of one-third of non-executive directors. This requirement is enforced by the Bursa Malaysia Listing Requirement in order for the board to be effective. When having only one non-executive director on the board, the director would not be able to challenge the actions of other board members and would tend to follow the majority.

In the previous studies, the board composition in Malaysian context comprised of a sufficient number of independent directors on the board, whether before the Asian Financial Crisis 1997-1998 or after the Crisis. Abdullah (2004), did his study of the roles of board independence and Chief Executive Duality on firm performance of the companies on the main Board of KLSE for the financial year between1994-1996. In the study, he found that the structures of the board in Malaysia for the three years period were dominated by the outside directors who are free from management. Thus, it means that the importance of independent directors has been realized even before the crisis.

After the Asian Financial Crisis, the other study on board composition also found that the board composition constitutes an adequate number of independent directors as stipulated in the MCCG 2000 that non-executive director should represent one-third of total board members. The study done by Wooi and Ming (2009) on 21 Malaysian Government-Linked Companies (GLCs) listed on Bursa Malaysia Main Board in year 2004 indicated that board independence ratio was 39.5% which is above the minimum requirement by Securities Commission as that of 33% of total board.

Similarly, in the study on 81 property sector companies listed on the main board of Bursa Malaysia for the period 1999 to 2005, the board composition was made up about 63.4% of non-executive directors (Shakir, 2010). Therefore, it showed the awareness of the Malaysian public listed companies on the essential requirement of independent directors on the board. However, if the independent directors just merely exist and do not perform the expected roles as required by shareholders, then the functions of independent directors will be ineffective. A sufficient number of independent directors on the board did not determine such directors were able to perform their roles effectively. This could be seen when the Asian Financial Crisis occurred, which gave a significant impact to the corporate sector.

3. Board Independence

Berghe and Baelden (2005) examined the issue of independence as an important factor in ensuring board effectiveness through the monitoring and strategic roles of the directors. The ultimate factor for the board independence is by acquiring enough numbers of the independent directors on board. They stated that the director's ability, willingness and board environment might lead to the independent attitude of each director.

Kakabadse, Yang and Sanders (2010) narrated the effectiveness of non-executive directors in China is determined by their formal independence, information accessibility, incentives provided and competency. However, they found out that the non-executive director system in China was weak because there was too much intervention of controlling shareholders and there was a lack of understanding of the functions of non-executive directors.

Johari, Saleh, Jaffar and Hassan (2008) indicated that the minimum composition of the independent director by the Malaysia Code of Corporate Governance is still not adequate enough to monitor the management. They concluded that the composition of the independent directors on the board was not associated with earning management. They found out that most of the firms in Malaysia have 1/3 or 33% of the independent directors on the board, but it did not have any effect on the earning management. Besides, Wooi and Ming (2009) indicated that the independent directors have failed in their internal monitoring role in Malaysian Government Linked Companies (GLCs).

Nowak and McCabe (2008) have studied the roles of the independent directors in Australian public listed companies by interviewing 30 directors. The participating directors agreed that a majority of non-executive directors (NEDs) on the board would provide a safeguard for a balance of power or management relationship. Besides that, there was a distinction between the boards with independent non-executive directors and non-independent directors. Independent directors would provide a variety of independent thinking, and majority of them could reduce the dangers of 'group think'.

Some researchers also analysed the relationship of the Chief Executive Officer (CEO) with the board's independence. Abdullah (2004) indicated there was no association between the board's independence and the CEO's duality with performance. Conversely, Byrd, Cooperman and Wolfe (2010) found a relationship between the attendance of outside directors and the payment of CEO remunerations for United State banking sectors. When the outside directors attend at least 75 percent of the board meetings, the CEO remuneration would be low. The independent directors who were regularly attending meetings would be better in monitoring of excessive payment to the CEO.

A study by Ararat, Orbay and Yurtoglu (2010) on the board independence in controlled firms in Turkey found three main important findings. The first finding indicated there was no significant effect of board independence and equity issue. Besides, the independent directors in Turkey were less efficient in restraining related party transactions. Also, they found that there was a negative relationship and a non-relationship of independent directors and firm's performance. The results were due to the fact that independent directors of Turkey's listed companies were not truly independent. The independent directors had personal, financial, and social ties with the dominant shareholders and this influenced their independent judgement, thus jeopardizing their functioning as independent directors.

4. Relationship between Board Independence and Firm Performance

The term independent directors were used interchange with term non-executive directors and outside directors. However, not all non-executive directors are independent. The study on board independence and firm performance showed mixed results; either positive, negative or no relationship with firm performance. Few studies also look at the relationship between board independence and earning management. Firm performance is studied by using market-based measure or accounting based measures. The accounting based measure through Return on Assets (ROA), Return on Investment (ROI), earnings per share and profit measures. Meanwhile, market-based measure carried out in many studies by using Tobin's q for market value.

The study in India showed that by having board independence did not guarantee to improve firm performance due to poor monitoring roles of independent directors (Garg, 2007). One of the vital roles of independent directors is to monitor the company's performance and operation. Effective monitoring mechanism in the firm could reduce agency problems. Thus, the company should appoint independent directors who could exercise proper oversight function in monitoring governance, internal control and risk management. Similarly, Hermalin and Weisbach (1991) found out no relation between firm performance and the proportion of outside directors. The study used the Tobin's q to measure the firm performance by using mixes market-based and accounting based measures.

Epps and Ismail (2009) indicated that firms in United States with annually elected boards, small size boards, 100 percent independent nominating committees, and 100 percent independent compensation committees have more negative discretionary accruals. Similar with Cybinski and Windsor (2013), the independence remuneration committee may align CEO remuneration with firm performance in larger Australian Stock Exchange (ASX) as compared to smaller and medium ASX300 firms. It showed that independent directors were having a crucial function of the monitoring remuneration process of CEOs and executive directors for larger public companies, and later the remuneration paid to them commensurate with their performance.

This is similar to the results found on the association of the board independence and the earning management (Johari, Saleh, Jaafar & Hassan, 2008). It showed that the board's independence was not associated with the earning management even though the proportion of independent directors on the board was one-third of the total majority. This means that even though the company had many independent directors on the board, it would not increase shareholders' return. Abdul Rahman and Mohamed Ali (2006) concluded that Malaysian companies had insignificant relationship between other corporate governance mechanisms such as the independence of the board, and the audit committee with the earnings management. It relates to the ineffectiveness of the board directors in their monitoring roles due to the dominant role of the manager and the executive directors in board matters.

In Hong Kong firms, study on board committee independence and firm performance in family firm showed no association. However, there is a positive relationship between board independence and firm performance in non-family firms (Leung, Richardson and Jaggi, 2013). It is due to the minority of independent directors in family firms as compared to non-family firms. The recommendation by regulators on composition of independent directors on board is voluntary basis. If the company could not comply, they may explain for the non-compliance. From the results, the independent directors' views would help companies to improve their corporate performance.

In contrast, a research was carried out by Abdullah (2004) in the year 1996. The study measured the relationship between the percentages of independent directors at 412 Companies in the Main Board of KLSE with the firm's performance. It showed positive and significant correlation with returns on assets, profit margin and earnings per share. From that finding, it showed that the board's independence might contribute to the effective performance of a firm. It showed evidences that the high number of independent directors on the board influenced the company's financial performance.

Therefore, it is essential to have independent directors on the board since it resulted in better firm performance. This is parallel to the functions of the independent directors to maximize shareholders' wealth. Ameer, Ramli and Zakaria (2009) have studied the association between the board composition and firm's performance of the 277 non-financial listed Malaysian Companies. They found out that over the period of 2002 to 2007, companies with high representation of outside and foreign directors on the board had a significant correlation with the company's better performance. They segregated the board into four types. They were classified as "bullies", "buddies", "believers", and "best of all". They found out most of the firm's board over that period could be classified as the "bullies", and the percentage of the insider directors were more than 50 percent of the total board. A study of 279 Malaysian firms listed on the KLSE and 271 Singapore firms listed on the Singapore Stock exchange for the year 2000 showed the proportion of independent directors on the Audit Committee is significant and negatively related to abnormal accruals (Bradbury, Mak and Tan, 2006). This means that the higher the number of independent directors on the audit committee, the lower the abnormal accruals which are associated with the roles of the independent directors when present in audit committee.

The study on company listed on the New Zealand Stock Exchange from the period 2007-2011 showed a significant negative association between the number of non-executive directors and firm performance (Fitriya Fauzi and Locke, 2012). It means the greater in the number of non-executive directors on the board, the lower the firm performance. The negative association may be due to high block holders' own, which makes non-executive directors become powerless in board discussion. However, they found out a significant positive association between the non-executive directors and Return on Assets (ROA). The non-executive directors on the board may ensure management uses the company's assets efficiently to generate income. A studied done in Pakistani's board also found a negative association between the proportion of outside directors and corporate performance. It is due to the small number of outside directors on the board (Sheikh, Wang and Khan, 2013).

Board independence ensured good corporate governance practice by the companies. Foo and Zain (2010) studied the sample of 481 Public-Listed firms in Malaysia at the end of the year 2007 for board independence, board diligence and liquidity. There was a significant association between the board independence and the disclosure of information. It means when the board was independent, it would be more transparent and would disseminate information which later results in improving the firm's liquidity.

5. Conclusion

The representation of independent directors on the board should show a positive relation to the firm's performance. If there were no association or negative relationship with the firm's performance, the performance of such independent directors on the board were jeopardized. Wang and Oliver (2009) mentioned that the company might comply with the required number of the independent directors on the board, but several tactics were done to neutralize the powers of such directors. The executive directors might appoint someone that has had experience in passive board, irrelevant background or without knowledge to challenge the executive powers. With regard to the mixed results of the relationship between independent directors and firm's performance, Wallison (2006) argued that having independent directors on the board was not for better performance but for better governance. They would represent shareholders to monitor the activities of management and executive directors in raising company's performance. Therefore, the executive directors would not have any chance to do any wrongdoings in their self-interest.

The company applies good governance is not only to bring profit to the company, but it will enhance corporate social performance. In the stakeholder value approach, companies should exercise its corporate accountability to various companies' stakeholders. It has shifted from protecting shareholders' interest in preserving stakeholders' interest. The interests of stakeholders are various and company must know how to consider the interests. The independent directors on the board would monitor the company performance in order to ensure the company's strategy should also consider in stakeholders' interest not on the management interest.

Using data from the manufacturing firm which listed in the Compustat S & P 500, board independence has a significant positive association of performance of firms pursuing a strategy on cost efficiency rather than strategy on innovation (Gani and Jermias, 2006). Meanwhile, the higher proportion of outside directors on the board can monitor the opportunistic behaviour of top management and mitigate the agency problem (Fama and Jensen, 1983). Board independence also can help to mitigate bad corporate reputation due to the disclosure of information to shareholders (Zhang, 2012). Further, a previous study by Dunn and Sainty (2009) on the relationship of the board characteristics and corporate social performance, showed a positive relationship. A quantitative survey of 104 Canadians firms showed that the company with a large number of independent directors on the board was more socially responsible. The company would be more aware and more sensitive to the needs of other stakeholders and also have a greater social responsiveness.

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