IMPACT OF INDEPENDENT DIRECTORS AND REMUNERATION COMMITTEE ON FIRM PERFORMANCE? EVIDENCE FROM MALAYSIAN CAPITAL MARKET

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Abstract

This study aims at re-examining whether or not the structure of the corporate governance as defined by the non-executive director matter that lead to better performance. This study is based on 100 firms listed in first board. The analysis is based on a period of 5 years from 1999 through 2003. This study employs a multiple regression methods to examine governance structure and its impact on firm performance. Although previous studies in developed markets exhibit the existence of relations between governance structure and corporate performance, this study however concludes that there is partial relation between corporate governance structure and corporate performance. However, the presence of both audit and remuneration committee serves an important monitoring device to control management actives that lead to increase firm's performance.

Keywords: corporate governance, performance, non-executive independent directors, remuneration committee

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1. Introduction

The issue of corporate governance has been the focus of interest among academics, investment publics and policy makers due to its strategic implication for the firm's value, monitoring effect of management activities. The issue has gained popular attention in the recent years after the collapse of Enron, a giant utility firm and the collapse of World.com, a worldwide telecommunication giant in United State. Therefore, it is a question of interest to determine whether or corporate board structure and audit & remuneration committees are s instrumental in ensuring the interest of the shareholders are well protected.

So far there is no universally agreed definition on corporate governance that has been termed. And it is not a term of art too. Instead it is a form of self-regulation. It aims to ensure a process to be implemented within an organisation to direct the company affairs to be conducted with a view to enhance business prosperity and corporate accountability. Since directors are the custodian of the firms and are being elected by the owners to safeguard their very interest, there is ardent need to examine the corporate governance structure and any other forms that self regulate the management activities.

Malaysia introduced voluntary code of corporate governance in 2002. The companies listed on Bursa Malaysia are required to make public the statement of Corporate Governance incorporating disclosure on directors' remuneration. Under such code of conduct, listed companies are required formally to establish procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors and companies are advised to establish a remuneration committee consisting of wholly or mainly non-executive directors particularly after the collapses of Enron and World.com. This is to increase the transparency and disclosure requirements of annual report and management decision-making processes. Nonetheless, there are other who view for the case of Chinese own companies in Malaysia that Independent non-executive directors are appointed to the board according to the Chinese entrepreneur's own definition of independence (Low, 2003). These Independent Non-Executive Directors often sit on the board as a mere obligation to the entrepreneur, and for loyalty vote in the event of a countdown (Tong & Yong, 1998). As suggested in Tong andYong (1998), independent non-Executive directors are not truly independent in Chinese controlled companies in Malaysia, therefore, they cannot be expected to carry out the monitoring function effectively. Thus, their presence on the board is unlikely to improve financial performance of the company. This is especially so in Malaysia when annual general meetings are usually poorly attended, and resolutions are passed with hardly any debate (Low, Yong & Shanmugam, 2004).

The existing literature on the importance of board composition and its structure on firm performance has been limited both developed and developing economies. The pioneered in such issue has been addressed by, Jensen (1993) argues that small boards are more effective in monitoring a CEO's actions, as large boards have a greater emphasis on ''politeness and courtesy'' and are therefore easier for the CEO to control. Yermack (1996) finds an inverse relation between board size and Tobin's q in a sample of industrial companies, and concludes that large boards are less effective than small ones. However, in Malaysia so far no systematic evidence on this issue is well documented. Therefore, this paper aims at identifying relationship between the Corporate Governance structure and the corporate performance**.** The paper is organized as followed. Section two present the evidence on corporate governance and section three briefly describes the methodology used to examine the said relationship. The findings and conclusions are presented in section four and five respectively.

2. Review of the literature

Recent development in the theory of the firm emphasizes the importance of monitoring management activities. A good corporate governance structure may resolve agency problem issues surface in the firm level. Jensen and Meckling (1976) argue that there is an inherent agency conflict exists between owners and managers because of divergence of interest and utility maximization. One way to mitigate this problem is to have independent non-executive directors to provide objective judgement about firms performance and oversee the management activities, while having independent remuneration committee may also give oversight about remuneration for executives. There is a great of literature on the director composition and likely impact on firm performance. For example recent empirical papers have examined the idea that the ideal board structure may vary with firm characteristics. Denis and Sarin (1999), Gillan, and Starks (2000), Gillan et. al (2003), Lehn, Patro and Zhao (2003), and Boone, Field, Karpoff and Raheja (2004), among others, have found crosssectional differences on board size and composition.

A number of studies have also linked the proportion of outside directors to financial performance and shareholder wealth (Brickley et al., 1994; Bryd and Hickman, 1992; Subrahmanyan et al., 1997; Rosenstein and Wyatt, 1990). These studies observed a better stock returns and operating performance when outside directors hold a significant percentage of board seats. But overall, existing evidence has yielded mixed results about the types of board characteristics that facilitate effective monitoring and improved governance (see surveys by John and Senbet (1998) and Hermalin and Weisbach (2003)). Furthermore, very little theory has emerged to provide insights into the effects of different board structures on firm value (Charu, 2005).

While Conyon (1997) examines the influence of remuneration committee adoption in UK companies as a monitoring substitute, and finds that, in some circumstances, the adoption lowers the growth rates in top director compensation. Conyon and Peck (1998) investigate the affect of outside directors in remuneration committee decisions, and report that they enhance the pay-for-performance sensitivity. However, studies in the US by Anderson and Bizjak (2003) and Vafeas (2003) report insignificant results on the influence of remuneration committee independence towards level of CEO pay. A more recent study by Sun and Cahan (2009) attempts to provide explanation for the mixed findings. Using a broader and richer measure of remuneration committee quality instead of just focusing on independence, they show that the sensitivity of CEO compensation to accounting performance is related to the governance quality of the remuneration committee, for US companies with fully independent remuneration committees.

To further search on the board structure, Benjamin and and Weisbach (1991) examined the effects of board composition and director incentives in public utility firms' performance and find that compensation packages for senior managers somehow have impact on firm performance. In a related study, Catherine Dail and Dalton (1992) focused specifically on the role of founder chief executive officers and the composition of boards of directors on corporate performance. They found some support for the ability of founder and non-founder CEOs to relinquish the tight control and effectively guide the growth of the firms. They further suggested that there are strong linkages between the CEO and directors and firm performance among the largest firms. Furthermore, the evidence also suggest that even strongest linkages are evidenced in the more modestly sized firms.

Anup and Charles (1996) examined seven mechanisms to control agency problems between managers and shareholders. These are shareholdings of insiders, institutions, and large block shareholders, use of outside directors, debt policy, the managerial labour market and the market for corporate control. The findings show a significant relationship between firm performance and four of the mechanisms stated above when each is included in a separate OLS regression. James and Morra (1997) has reviewed the book of "Corporate Decision Making in Canada and concluded that there is no existence of relationship between corporate governance and corporate performance. Similar study was also further searched by Ned Regan (1998) and examined the relationship between the board governance and corporate performance. However, no significant relationship was observed between the corporate governance and corporate performance.

Further search on issue was again documented by Scott and Rosenstein (1998). They examined the relationship between board composition, managerial ownership and firm performance. The results indicate some support for the curvilinear relationship between managerial ownership and performance posited by Stulz (1988) and empirical research of Morck, Shleifer and Vishny (1989) and McConnell and Servaes (1990).

David and Wier (1999) has analysed the extent of Cadbury compliance of corporate governance and its impact on corporate performance in UK firms. The study evidenced that the duality is less common while firms tend to have more than 3 non executive directors and there has been an almost universal adoption of board subcommittees such as the remuneration and audit committee.

Data and Methodology

A sample of 100 firms most of which are drawn from CI component firms, serve as market barometer over the period 1997 through 2001. The proxy for board structure is derived from number of non-executive director to total directors governance and firms performance are extracted from companies annual handbook, companies annual reports and many other sources. The choice of period is of significant for two reasons. Firstly Malaysia economy recovered from worst financial crisis in 1999. Secondly after the Asian Financial Crisis Malaysia adopted code of conduct on corporate governance on March 2000.

Operational Model

$$Yit = \beta_0+\beta_1 NEDit)+ +\beta_5(COMit)+\beta_6(MKTCPit) + \varepsilon$$

Where

- Yit – this is corporate performance proxied by level of net income before tax divided firm's total asset at period t.
- *Indirec* – This is the binary variable which has a value of one if independent non executive directors represent at least 50 per cent of the board and zero for otherwise.. It expects organisations with more than 50 per cent of independent non executive directors would have better monitoring system.
- *Committees* – This refers to the presence of audit and remuneration committee. It is a binary variable taking a value of one if a company has both committees and zero for otherwise. It is believed that there is positive relationship between the presence of committee and performance
- *Size* – This is measured by market capitalisation and is used as a control measure to analyse the extent of size effects present in the governance structure.

Findings: Table One

* , **,*** significant at 10%, 5% and 1% level respectively. Durbin Watson 2.0162. F-value 2.9842 (P=.0234)

Variable\t-value	1997	1998	1999	2000	2001	Average t-value
Indirect	1.59*	-0.197	-3.541***	-1.19	0.641	-0.5394
Com	2.056**	2.609***	2.014**	1.236	0.635	1.71*
MKTCP	1.914**	1.13	2.725***	2.842***	2.677***	2.2576***
R-Square	0.171	0.158	0.219	0.12	0.131	0.1598

Table-1 shows the findings from the annual regression over a period from 1997 to 2001. However, to examine over all effect of board structure on corporate performance, the significant of the t-value are averaged up over the 5 years period. To isolate the size effect on corporate performance, a control variable is included into the model which is proxied by the market capitalization of the respective firm. The findings appears to suggest that the presences of both audit and remuneration committees as proxied for corporate governance structure does play an important roles for the firms performance for the period 1997 to 1999 (economics downturn). However, the dominance of independent non-executive directors provides no apparent explanation for firm performance, except in year 1997. Surprisingly, finding of a negative and significant relationship between independent non-executive directors and firm performance for year 1999 is rather astonishing. This could be due to the fact that listed firms particularly after financial crisis tend to have more of non-executive directors as part of the board structure to window Dress Company's outlook. Thus, corporate governance structure can explain partially explain for the performance of the firms. The percentage of independent non-executive directors is not found to have any significant impact on firm performance. The average R-square of 15.8% suggest that changes in corporate performance is partially explained by selected corporate governance variables included into the model. The model is significant at 5% level with the f-value of 2.948.

Conclusion

Corporate Governance is widely accepted worldwide since the publication of Cadbury Report in 1992 in UK. However, it has been adopted by the London Stock Exchange in 1995 and Kuala Lumpur Stock Exchange in only 2000. As the analysis period consists of 5 years from 1997 to 2001, this is not intended to examine the compliance effect of such

code of conduct in this paper. Although previous studies in developed market exhibits the existence of relations between governance structure and corporate performance, this study however concludes that there is partial relation between corporate governance structure and corporate performance over the period 1997 to 2001. While the presence of independent non-executive directors does not have any significant impact on firms performance except for the year 1997 and 1999. However, the firm size appears to have significant impact on corporate performance.

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