RELATIONSHIP BETWEEN FIRM OWNERSHIP AND PERFORMANCE: THE MEDIATING ROLE OF INTERNAL GOVERNANCE MECHANISMS

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Abstract

This paper explores the role of selected internal governance mechanisms as mediators of the relationship between ownership and firm performance. Data from 2004 and 2005 was gathered from 177 firms listed on Bursa Malaysia. Structural equation modelling was used as the primary statistical analysis approach. Insiders and blockholders were found to compete for board dominance. Selected internal governance mechanisms mediate the effect of ownership on performance, suggesting that these were used to advance the investment interests of insiders/ blockholders. The paper provides empirical support for the interest-alignment hypothesis, arguing that the use of governance mechanisms that align the interest of managers and shareholders are more effective than monitoring mechanisms.

Keywords: corporate governance, internal control, shareholders

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Introduction

Adam Smith (1776) famously cautioned against the moral hazards that would result when the capital and resources of firms are controlled and managed by individuals other than the shareholders. Berle and Means (1932) expounded on Smith's work and theorized the agency costs in the relationship between principals as shareholders and managers as agents who deploy the resources owned by the shareholders to profitable use. Central to their thesis is the assumption that shareholders and managers are driven by divergent interests. As a result, managers are motivated to expropriate firm value at the expense of shareholders, for their private benefit. Following Berle and Means's (1932) seminal paper, there has been a long line of research on issues of corporate governance in the context of large firms in the developed economies.

Tam and Tan (2007) describe corporate governance as a weak link in Asia. The rapid pace of growth in many of Asian newly industrialized economies have not afforded a mature, well-functioning corporate governance framework. Although the Asian financial crisis during the late 1990s has highlighted the importance of good governance, it remains unclear if vital lessons have been learned. Drawing on a sample of 177 firms listed on Bursa Malaysia, this paper presents a cross-sectional study on the relationship between firm ownership, internal governance mechanisms and firm performance. Statistical data from 2004 and 2005 was used, these being approximately seven years following the initial outbreak of the Asian 'contagion' in Thailand, back in 1997.

In the wake of the Asian financial crisis, the Malaysian government has established a High Level Finance Committee in 1998 with the objective of setting up a sound corporate governance framework to better regulate the stock market (Shim 2006). A Report on Corporate Governance was subsequently published in 1999, leading to the introduction of the Malaysian Code of Corporate Governance in 2000. These initiatives were seen as critical in order to reverse the massive capital outflow from the country and regain institutional investors' trust of the market. Although the guidelines prescribed by the Code are expansive, as of date, it remains unclear if the Code has successfully contributed to the reformation of corporate governance among Malaysian firms. The main rationale for this lies in the fact that the majority of the guidelines are normative in nature, with their adoptions by firms, voluntary rather than enforceable under the law. In this vein, it is not surprising that firms will only adopt the guidelines to the extent that these serve the greater interests of those controlling the firms.

Firm Ownership and Performance

Share ownership of Malaysian firms tends to be concentrated in the hands of a relatively small number

of individuals, families and state enterprises (Shim 2006). Individuals and families with controlling stakes are often actively involved in the management of the businesses. They directly control the deployment of firm capital, have more information about their firms and dominates both strategic and operational decision-makings. The extant governance literature offers two contrasting views on the impact of high managerial ownership on firm performance. On one hand, increase in managerial ownership is seen as promoting the alignment of interests of managers and shareholders. As managers own more shares in their firms, they are naturally driven towards maximizing firm value, given that doing so will enhance the returns from their investment.

On the other hand, increase in managerial ownership places them in a stronger position to expropriate firm value at the expense of minority shareholders (Jensen & Meckling 1976). Previous studies have documented the tendency of controlling owner-managers to exert control over the firm via cross-shareholdings (which increases their voting rights), appoint a compliant board, engage in unfair related party transactions, borrow excessively from banks, only to divert much of the capital to themselves (i.e. as loans with minimal interests), reward themselves with overly generous compensation, and embark on wealth-decreasing diversification (Bae et al. 2002; Baek et al. 2004; Chang 2003; Joh 2003).

Recent empirical studies have examined the relationship between share ownership by managers, blockholders and outside directors on firm performance. Their findings in general suggest that the effect of ownership concentration varies along different levels of ownership. Cho & Kim (2007) performed quadratic equation regressions to gauge the effect of blockholder ownership on firm performance, using a sample of 600 Korean public listed firms and found a bell-shaped relationship between ownership and performance. Their findings suggest that initial increases in ownership concentration benefit the firm as a result of interest-alignment. However, further increases would eventually produce a negative impact on the firm as dominant shareholders are immune from external market discipline. Sheu & Yang (2005) examine 333 Taiwanese electronics firms using panel data from 1996 to 2000. Their findings indicate the existence of a U-shaped relationship between managerial ownership and productivity, highlighting the importance of top officer commitment in improving firm performance and reducing agency costs.

In Tam and Tan (2007)'s study on the governance practices of 150 Malaysian firms, they found no significant relations between ownership concentration and firm performance. They nonetheless found variations in the performance of firms with different ownership types. Specifically, firms with significant foreign ownership outperform firms controlled by individuals and the government. According to them, the causation between ownership concentration and firm performance may also run in the opposite direction. Individuals or families may increase their stake in high-value firms, because these firms offer greater returns for their investment.

In the present study, we hypothesize that equity ownership by insiders (i.e. CEO, executive directors and other directors related to the CEO) and blockholders have significant effects on firm performance. Following the interest-alignment hypothesis, owner-managers and blockholders may be motivated to act in a manner that benefits the firm as the returns of their investment is tied to the overall performance of the firm (Morck et al. 1988). Nevertheless, high ownership concentration may also raise the risks of them expropriating firm value at the expense of minority shareholders. As a result, firm performance as a whole may suffer. In view of these, the following hypotheses are developed:

H_1: Insider ownership is significantly related to firm performance.

H_2: Blockholder ownership is significantly related to firm performance.

Firm Ownership, Governance Mechanisms and Performance

The agency theory advocates for the adoption of distinctive corporate governance mechanisms to monitor and discipline any opportunistic intentions to expropriate firm value (Core & Larcker 2002). Among the internal control mechanisms which are proposed in the literature include the appointment of a board of directors that monitors the management (Fama & Jensen 1983), supervision by external shareholders (Demsetz & Lehn 1985) and the use of performance-based compensation plans (Murphy 1985). This can be contrasted with external control mechanisms which include threats of corporate takeovers, competition in product markets and the market for management personnel (Lin 2005).

Sheu and Yang (2005) conceded that emerging markets are typically characterized by a lack effective legal framework for shareholder protection, the absence of active takeover market and strong institutional investors. As a consequence, corporate governance is undertaken primarily with the use of internal control mechanisms. The present study focuses on the role of board characteristics and compensation as governance mechanisms. Nicholson and Kiel (2007) point out that the board functions as an essential link between the shareholders, management and external stakeholders. It plays a monitoring role in safeguarding the interests of all shareholders, ensuring that managers would deploy firm capital and resources to maximize shareholder

returns.

Lin (2005) for instance, noted that corporate law gives the board the powers to appoint and dismiss, as well as decide the compensation of CEOs, thereby curtailing the risks of managerial entrenchment. The resource-based theory of the firm (Barney 1991) suggests that the board links the firm to its external environment, providing access to valuable resources and information that it needs to maximize performance (Johnson et al. 1996). Board members with cross-industrial experience would be able to advise the management on broader corporate-level strategic decision-making.

Garcia and Anson (2007) pointed out that characteristics of the board which may influence its monitoring capacity include its size, composition and duality of leadership. Nam and Nam (2004) state that board size should be large enough so as to secure sufficient expertise on the board, but not so large that productive discussion becomes impossible and free-riding among directors is prevalent. The Malaysian Code of Corporate Governance (2000) states that the optimum number of board members should be appropriately determined so as to ensure that there are enough members to discharge responsibilities and perform various functions. Malaysian firms have on average 8 board members (Abdullah 2001).

Fama (1980) argued that a board with larger fraction of outside directors will be more effective in mitigating managerial entrenchment by managers. Integrity of the board will be further enhanced with the appointment of independent directors, namely those that do not own shares nor participate in managing the firms. A further measure for strengthening the board's monitoring role is by separating the roles of CEO and Chairman of the board.

Previous studies on corporate governance are largely undertaken using samples of large firms in the US and UK. These tend to be characterised by dispersed ownership and greater separation between ownership and management. The focus of these studies were on the agency costs that arise from the control of firm by managers without substantial shareholdings, whom in the absence of effective monitoring, are likely to expropriate firm value. Public-listed firms in developing economies, including Malaysia however, are characterized by lower market capitalization and higher levels of ownership concentration. As stated earlier, significant shareholders and insiders tend to dominate both the management and board of the firms (Nam & Nam 2004). Outside and independent directors are often removed from daily managerial routines and would only meet periodically. As a result, they lack the knowledge, both in depth and scope to meaningfully contribute to complex management decision-making.

We attempt to examine the effect of insider and blockholder ownership on board characteristics and compensation. The board characteristics or governance mechanisms are board size, board composition, board independence and CEO duality. We postulate that insiders and blockholders exert control over the firm by influencing the board governance mechanisms and compensation of executives, either as measures to protect their investments or to expropriate firm value. Specifically, board governance mechanisms and executive compensation would mediate the relationship between insiders and blockholders, and firm performance. The following hypotheses are developed for the present study:

H_3: Board governance mechanisms and executive compensation mediate the relationship between insider ownership and firm performance.

H_4: Board governance mechanisms and executive compensation mediate the relationship between blockholder ownership and firm performance.

H_5: Insider ownership is significantly related to board governance mechanisms and executive compensation.

H_6: Blockholder ownership is significantly related to board governance mechanisms and executive compensation.

Methods

Data

The present study attempts to examine the relationship between insider and blockholder ownership, selected internal governance mechanisms and performance of Malaysian listed companies. The sample consists of 177 multi-sectoral firms listed on Bursa Malaysia. Data was gathered for 2004-2005 and was sourced from the firms' annual reports.

Measures

A range of variables measuring ownership, governance mechanisms and firm performance were defined.

Insider and blockholder ownership- We distinguish between the ratio of insider ownership to total outstanding shares, as well as the ratio of blockholder ownership to total outstanding shares. Insider ownership is measured as the sum of direct and indirect shareholdings of all executive directors, the CEO and his/her immediate family members. Blockholder ownership is measured as the total shareholdings of all individuals or institutions that own at least 5 percent of shares.

Board characteristics and executive compensation- We examine the boards of the sampled firms by measuring board size, board composition, board independence and CEO duality. Board size is defined as the total number of board members. As for its composition, we measure the ratio of inside directors

and outside directors to board size respectively. Outside directors refer to directors that may own shares but are not involved in management. The degree of board independence is defined as the ratio of independent directors to board size. CEO duality refers the combination of the roles of CEO and Chairman. The variable is coded "1" if the CEO also serves as Chairman and "0" if the roles are separated and served by different individuals. We calculate executive compensation as the sum of the salary and bonuses received by executive directors and CEO in a given year.

Firm performance- Three measures of firm performance are used, namely, return-on-assets (ROA), return-on-equity (ROE) and earnings per share (EPS).

Control variables- To control for the influence of firm size, we calculate the book value of firm assets and revenue as two proxies of firm size. Consistent with previous studies, we also incorporate ownership ratio of outside directors in our analysis.

Data Analysis

Descriptive statistics for ownership, board characteristics, executive compensation, firm size and performance are reported in Table 1. On average, insiders own 28 percent of outstanding equity, while blockholders own 46 percent. Board size ranges from 4 to 15 members, with a mean of 8. The mean size conforms to Lipton and Lorsh's (1992) recommendation that the preferable board size should be 8 or 9 with 10 being the maximum. The mean value for the fraction of insiders and outsiders on the board are 34 percent and 63 percent respectively. Independent directors made up 39 percent of board members. The mean size conforms to the Securities Commission's listing requirement that at least one-third of board members should consist of independent directors. The mean amount of compensation received by executives is RM2.7 million.

A great majority of the firms have separate individuals assuming the roles of CEO and Chairman. This appears to be in line with the Malaysian Code of Governance's recommendation for the separation of the CEO and the board Chairman. Mean ROA and ROE are 10 percent and 35 percent respectively, while mean EPS is RM11.78. On average, the sampled firms have assets of RM1 billion, achieving mean annual sales of RM721 million. Outside directors own on average, only six percent of total outstanding shares.

Table 1. Descriptive statistics of the variables

	N	Minimum	Maximum	Mean	S.D.
InsiderOwn	177	0.00	0.76	0.28	0.24
BlockholderOwn	177	0.00	0.87	0.46	0.19
BDSIZE	177	4.00	15.00	7.67	2.05
Insider size	177	0.00	0.71	0.34	0.20
Outsider size	177	0.29	0.94	0.63	0.18
Board independence	177	0.00	0.80	0.39	0.14
CEDUAL	177	0.00	1.00	0.19	0.39
EXDRCOMP	177	0.00	163,944,625	2,709,517.55	12,415,451.54
ROA	177	-2.87	3.02	0.10	0.34
ROE	177	-6.96	57.96	0.35	4.40
EPS	177	-282	241	11.78	34.18
Sales	177	151,122	10,843,816,000	720,509,198	1,505,045,785
Asset	177	15,817,495	8,529,166,000	1,036,035,827	1,422,015,152
OutsiderOwn	177	0.00	0.77	0.06	0.12

A correlation coefficient analysis is performed to examine the relationships between the variables, hence providing preliminary evidence on whether the nature of relationships conforms to established hypotheses. Analysis of the skewness and kurtosis values of the variables indicate that many variables have significant non-normal distribution. These are subsequently treated using logarithm transformations. Table 2 reports the correlation coefficients between the variables. Insider ownership has significant positive correlations with the fraction of insiders on board (.434**) and CEO duality (.221**), while negatively correlated with the fraction of outsiders on board (-.492**), sales (-.166*), asset (-.209**) and outsider ownership (-.262**). Blockholder ownership has a significant and positive correlation with sales (.151*).

The hypotheses of the study are tested via structural equation modeling (SEM), using the AMOS software. A hypothesized structural model M_1 which described the relationships between the ownership variables, firm size and firm performance is developed. We specify firm size as a latent construct, measured by

two indicators, namely, firm asset and firm sales. Another latent construct, firm performance, is measured by three indicators, namely, ROA, ROE and EPS. Model M_1 is estimated using the Maximum Likelihood (ML) method. Assessment of model fit indicated a good fit between the model and sample data, thereby providing assurance for goodness of the model. Goodness-of-fit values of the model are shown in Table 3, where, almost all benchmarked values for fit indices are achieved.

Table 2. Correlations between the variables in the study

	InsiderOwn	BlockholderOwn	BDSIZE	Insider size	Outsider size	LgBDINDP	LgCEDUAL	LgEXDRCOMP	LgROA	LgROE	LgEPS	LgSALES	LgASSET	LgOUTOWN
InsiderOwn	1													
BlockholderOwn	0.08	1												
BDSIZE	-0.09	0.14	1											
Insider size	.43**	-0.14	-0.04	1										
Outsider size	-.49**	0.15	0.05	-.96**	1									
LgBDINDP	-0.01	-0.06	-0.13	.23**	-.16*	1								
LgCEDUAL	.22**	-0.01	-0.12	.18*	-.15*	0.04	1							
LgEXDRCOMP	0.14	-0.13	.32**	.19*	-.21**	0.07	0.06	1						
LgROA	0.01	0.08	0.06	0.11	-0.08	-0.10	0.02	-0.02	1					
LgROE	-0.07	-0.07	.18*	-0.02	0.02	-0.10	-0.03	0.10	0.07	1				
LgEPS	0.03	0.03	0.06	-0.05	0.05	-0.06	-0.09	-0.02	0.04	0.10	1			
LgSALES	-.17*	.15*	.27**	-.15*	.17*	-0.04	-0.03	0.15	0.11	.16*	0.10	1		
LgASSET	-.21**	0.05	.25**	-.17*	.19*	0.02	0.03	0.07	.18*	0.08	-0.01	.68**	1	
LgOUTOWN	-.26**	-0.04	0.06	-.28**	.31**	-0.10	-0.07	0.05	-0.15	0.01	-0.01	-0.01	-0.07	1
**	Correlation is significant at the 0.01 level (2-tailed).													
*	Correlation is significant at the 0.05 level (2-tailed).													

Table 3. Goodness of fit of model M_1

Goodness-of-fit indices	Benchmark	Model M_2
CMIN/DF	1 to 3	1.26
P	>.000	.22
RMR	<.05	.00
GFI	>.90	.97
AGFI	>.80	.94
NFI	>.90	.88
IFI	>.90	.97
TLI	>.90	.95
CFI	>.90	.97
RMSEA	<.80	.04

Empirical Findings

The standardized parameter estimates for model M_1 is summarized in Table 4. Firm size exerts significant (t > 1.96), albeit different effects on the ownership variables. Negative effects on insider (-0.23, t = -5.51) and outsider ownerships (-.07, t = -8.50) highlight the limitations that these investors encounter in raising capital for the purchase of large amount of shares. Hence, in bigger firms, both insiders and outsiders are likely to hold smaller equity stakes. Tam and Tan (2007) point out that owner-managers in Malaysian

firms tend to have limited internal funds as these tend to be exhausted in the initial business set-up. The most common external financing option is loans from financial institutions, using firm or personal assets as collaterals. Due to the smaller size of the firms as compared to those in developed economies, the amount of capital that owner-managers are able to borrow is limited. Hence it is not surprising that in larger firms, insider ownership is relatively smaller than those among smaller firms (Suto 2003). In contrast, the significant positive relationship between firm size and blockholder ownership (0.07, t = 2.18) would suggest that large investors prefer to invest in larger firms, probably because these firms are less likely to be controlled by owner-managers or families. Furthermore, as they may have access to more sources of financing, it would have been easier for them to own large stakes in larger firms. With regards to the effects of the four exogenous variables on firm performance, only blockholder ownership (0.09, t = 2.25) and firm size are found to exert significant effects on firm performance (0.36, t = 18.84). The four variables nonetheless, account for 21 percent of explained variance in the endogenous variable firm performance.

To examine the mediating effect of board-related governance mechanisms and executive compensation, we estimate model M_2, where we introduce five additional variables into our analysis. These are board size, fraction of insiders on board, board independence, CEO duality and executive compensation. We exclude the fraction of outsiders on board due to its significant correlation (-.957**) with the fraction of insiders, so as to prevent the problem of multicollinearity. Table 5 summarizes the standardized parameter estimates for model M_2. It is apparent that the introduction of the five mediating variables has altered the values of regression coefficients which represent the direct effects of insider and blockholder ownerships on firm performance. The effect of insider ownership on firm performance turned negative and significant (-0.14, t = -3.75). The change suggests that the new variables moderate the relationship between insider ownership and firm performance. Hence, we reject hypothesis H_3. The effect of blockholder ownership on firm performance was not significant. This suggests that the board-related governance mechanisms and executive compensation mediate the relationship between the two variables. The findings provide empirical support for hypothesis H_4. The addition of the five variables also contributes an additional 34 percent of explained variance in firm performance, or a total of 55 percent.

Table 4. Standardized parameter estimates for model M_1

			Estimate	S.E.	t-value
InsiderOwn	<---	FirmSize	-0.23	0.04	-5.51
BlockholderOwn	<---	FirmSize	0.07	0.03	2.18
LgOUTOWN	<---	FirmSize	-0.07	0.01	-8.50
FirmPerf	<---	InsiderOwn	0.01	0.04	0.29
FirmPerf	<---	BlockholderOwn	0.09	0.04	2.25
FirmPerf	<---	LgOUTOWN	-0.23	0.18	-1.27
FirmPerf	<---	FirmSize	0.36	0.02	18.84
LgROA	<---	FirmPerf	0.51		
LgROE	<---	FirmPerf	0.14	0.29	0.49
LgEPS	<---	FirmPerf	0.08	0.44	0.19
LgSALES	<---	FirmSize	0.74		
LgASSET	<---	FirmSize	0.92	0.24	3.83

Table 5. Standardized parameter estimates for model M_2

			Estimate	S.E.	t-value
InsiderOwn	<---	FirmSize	-0.23	0.04	-5.73
BlockholderOwn	<---	FirmSize	0.09	0.03	2.69
BDSIZE	<---	InsiderOwn	-0.05	0.64	-0.07
Insidersize	<---	InsiderOwn	0.45	0.06	8.09
LgBDINDP	<---	InsiderOwn	-0.01	0.02	-0.33
LgCEDUAL	<---	InsiderOwn	0.22	0.04	6.19
LgEXDRCOMP	<---	InsiderOwn	0.15	0.20	0.74
BDSIZE	<---	BlockholderOwn	0.12	0.77	0.16
Insidersize	<---	BlockholderOwn	-0.18	0.07	-2.60

LgBDINDP	<---	BlockholderOwn	-0.06	0.02	-3.33
LgEXDRCOMP	<---	BlockholderOwn	-0.14	0.25	-0.56
LgCEDUAL	<---	BlockholderOwn	-0.02	0.05	-0.51
LgOUTOWN	<---	FirmSize	-0.06	0.01	-8.57
FirmPerf	<---	InsiderOwn	-0.14	0.04	-3.75
FirmPerf	<---	BDSIZE	0.12	0.00	30.25
FirmPerf	<---	Insidersize	0.38	0.04	8.95
FirmPerf	<---	LgBDINDP	-0.41	0.16	-2.56
FirmPerf	<---	LgCEDUAL	-0.05	0.06	-0.87
FirmPerf	<---	LgEXDRCOMP	-0.03	0.02	-1.50
FirmPerf	<---	BlockholderOwn	0.07	0.04	1.89
FirmPerf	<---	LgOUTOWN	-0.24	0.17	-1.41
FirmPerf	<---	FirmSize	0.48	0.02	26.44
LgROA	<---	FirmPerf	0.39		
LgROE	<---	FirmPerf	0.21	0.27	0.80
LgEPS	<---	FirmPerf	0.08	0.43	0.18
LgSALES	<---	FirmSize	0.76		
LgASSET	<---	FirmSize	0.89	0.18	5.08

Next, we look at the effects of the ownership variables on board governance mechanisms and executive compensation. Insider ownership exerts significant positive effects on the fraction of insiders on board (0.45, t = 8.09) and CEO duality (0.22, t = 6.19). These suggest that as insiders increase their equity stakes in the firm, they are likely to exert more control over the firm by dominating board membership and board leadership. The findings are consistent with those made by Tam and Tan (2007), who conclude that when owner-managers increase their shareholdings in a firm, they would seek to exert their dominance over the board in order to maximize their investment interests. The relationships between insider ownership and board size, board independence and executive compensation are not significant. Overall, the findings provide partial support for hypothesis H_5.

Blockholder ownership has a significant negative effect on both the fraction of insiders on board (-0.18, t = -2.60) and board independence (-0.06, t = -3.33). These results provide partial support for hypothesis H_6. Its effects on board size, executive compensation and CEO duality are not significant. The negative effect on the fraction of insiders on board highlight the competing interests of blockholders and insiders. According to Belkhir (2004), blockholders may seek to limit the influence of insiders in order to mitigate agency risk of insiders expropriating firm value through their dominance in the firm. The negative effect of blockholder ownership on board independence would suggest that while blockholders seek to limit the dominance of insiders, they may attempt to install outside directors who will represent their investment interests in the firm. To test the argument, we alter model M_2 by replacing the variable fraction of insiders on board with that of outsiders' and re-estimate the model.

The results show that blockholder ownership has a significant positive effect on the fraction of outsiders on board (0.19, t = 3.10) while the effect on board independence remains negative (-0.06, t = -3.33). In contrast, insider ownership has a significant negative effect on the variable fraction of outsiders on board (-0.50, t = -10.46) while the effect on board independence is negative and not significant. These findings support the argument that similar to insiders, blockholders too are motivated to secure their investment by installing outside directors who represent their interests while seeking to reduce the dominance of insiders. On a further note, both insiders and blockholders do not regard independent directors as an effective governance mechanism to protect their interests.

The direct, indirect and total effects of ownership variables, board-related governance mechanisms and executive compensation on firm performance are summarized in Table 6. Insider ownership has a significant negative direct effect on firm performance (-0.14). Its total effect on firm performance via the board-related governance mechanisms and executive compensation is positive but dismal (0.01). Likewise, blockholder ownership has a weak direct effect (0.07) and a weak total effect (0.05) on firm performance. Consequently, hypothesis H_1 and H_2 could not be supported.

With regards to board-related governance mechanisms, board size (0.12, t = 30.25) and the fraction of insiders on board (0.38, t = 8.95) exert significant positive effects on firm performance. The positive effect from board size highlight the role of the board as a key resource for competitiveness as an increase in the number of board members enhances the pool of knowledge and skills that the board can contribute to strategic decision-making. Abdullah

(2006) however, cautioned that an oversized board may give rise to problems of coordination and information asymmetry, resulting in a less effective board. In her study on Malaysian firms following the financial crisis, she found that board size is negatively related to firm performance. Nicholson and Kiel (2007) attribute the significant positive relationship between number of insiders on board and firm performance to asymmetrical distribution of information among board members. As insiders are involved in the running of the business, they have superior access to quality, up-to-date information, understand the business better and thus able to make better informed decisions, as compared to outsiders or independent directors.

Board independence has a significant negative effect on firm performance (-0.41, t = -2.56). This may be attributed to the nature of the appointment of independent directors in Malaysian firms. They may not be aware of their duties or are far removed from management to be able to meaningfully contribute to complex management processes. Likewise, they may be coerced by the management to assume a passive role via threats of removal from board or with generous rewards for being compliant (Cho & Kim 2007; Abdullah 2006; Corbetta & Salvatto 2004; Donaldson & Davis 1994). The significant positive total effect of firm size (.492) on firm performance is consistent with the nature of competition in Malaysia where larger firms with more resources tend to possess greater competitive advantage over less well-endowed firms. The effects of CEO duality and executive compensation were not significant.

Assessment of model fit indicate a good fit between model M_2 and the sample firms, thereby providing assurance for representativeness of the model. Goodness-of-fit values of the model are shown in Table 7, where almost all benchmarked values for different fit indices are achieved.

Table 6. Direct effects, indirect effects and total effects of variables on firm performance

Firm performance	Direct Effect	Indirect Effect	Total Effect
Insider ownership	-0.14	0.15	0.01
Blockholder ownership	0.07	-0.02	0.05
Outsider ownership	-0.24	0.00	-0.24
Firm size	0.48	0.02	0.49
Board size	0.12	0.00	0.12
Insider size	0.38	0.00	0.38
Board independence	-0.41	0.00	-0.41
CEO duality	-0.05	0.00	-0.05
Executive compensation	-0.03	0.00	-0.03

Table 7. Goodness of fit of model M_2

Goodness-of-fit indices	Benchmark	Model M_2
CMIN/DF	1 to 3	1.33
P	>.000	0.07
RMR	<.05	0.02
GFI	>.90	0.95
AGFI	>.80	0.90
NFI	>.90	0.81
IFI	>.90	0.94
TLI	>.90	0.90
CFI	>.90	0.94
RMSEA	<.80	0.04

Conclusion

The present study sets out to examine the relationship between insider and blockholder ownerships, and firm performance. It postulates that both parties influence firm performance through the adoption of board-related governance mechanisms and executive compensation which reflect their investment interests. In other words, equity ownership on its own does not affect firm performance. Instead, it serves as a means

to exert control over the governance and management of the firm, which in turn would affect firm performance. We hypothesize that board-related governance mechanisms and executive compensation would mediate the relationships between the ownership variables and firm performance. We found empirical support for the role of selected governance mechanisms as mediators. Insiders would exert their control over the firm through the appointment of more insiders on the board, as well as combining the role of CEO and Chairman of the board. Blockholders on the other hand, would seek to appoint more outside directors who represent their investment interests. These findings highlight the important role played by the board in governance and influencing strategic decision-makings, given that both insiders and blockholders seek to dominate its membership. The competing interests between the two parties are evident in that each not only seeks to increase its board representation, but also to decrease that of the other party. Interestingly, both insiders and blockholders do not view independent directors as an effective governance mechanism. We argue that independent directors in Malaysian firms generally play a passive role as their appointment is merely to fulfil listing requirement rather than as a measure at improving corporate governance or to bolster the strategic capability of the firm.

The interest-alignment hypothesis posits that equity ownership by insiders serves to align the interests of managers and the firm, thereby motivating insiders to maximize the wealth of the firm. Our findings support the hypothesis as the fraction of insiders on board has a significant positive effect on firm performance. Drawing on the stewardship theory, we argue that insiders as stewards of the firm are in a position to enhance firm value as they possess more superior information about the strategic complexities in running the firm. As a result they are capable of making quality and better-informed decisions as compared to outside or independent directors. Their dominance over the board would also afford them a longer-term investment perspective, as they would be more immuned from pressures to deliver short-term investment returns. We nonetheless, do not discount the agency risk of insiders consuming prerequisites as their dominance places them in a position to expropriate firm value at the expense of minority and external shareholders.

Overall, the study finds that in the context of Malaysian firms, characterized by high levels of insider ownership, mechanisms that align the interests of controlling owner-managers and the firm are more effective than monitoring mechanisms in enhancing firm performance. Insistence on traditional monitoring mechanisms will be detrimental to performance as they may create distrust, increase agency costs, and disincentives for investors to take-up significant shareholdings or adopt a long-term perspective.

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