INDEPENDENT NON-EXECUTIVE DIRECTORS, MANAGERIAL OWNERSHIP AND FIRM PERFORMANCE IN MALAYSIAN PUBLIC LISTED COMPANIES

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DEDICATION

….to my beloved parents

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ABBREVIATION

BSKL : **Bursa Malaysia Kuala Lumpur**

FCCG : **Finance Committee on Corporate Governance**

INEDs : **Independent Non-Executive Directors**

PLCs : **Public Listed Companies**

ABSTRACT

Leung and Horwitz (2004) argued that the failing of corporate governance and lack of transparency are often associated with the Asian financial crisis. Therefore, this study attempt to examine the relationship between independent non-executive directors and managerial ownership towards firm performance, as measured by Tobin’s Q. Sample consisted of 220 Main Board companies listed on the Bursa Malaysia in the year 2003. The study found the number of independent non-executive directors that on the board does not contribute to firm performance. The study also reveals that the compliance level of one-third of independent directors to PLCs as required by Bursa Malaysia’s listing requirement is satisfactory. Using piecewise linear regression analysis, this study captured non-linear relationship between managerial ownership and Tobin’s Q. However, the interaction effects between independent non-executive directors and managerial ownership on firm performance was not found to be significant.

ABSTRAK

Leung dan Horwtiz (2004) menerangkan kegagalan tadbirurus korporat dan kekurangan transparensi selalunya dikaitkan dengan krisis kewangan di Asia. Justeru itu, kajian ini meninjau perhubungan di antara pengarah bebas bukan eksekutif (INEDs) dan pemilikan pengurus syarikat terhadap prestasi firma. Kajian ini menggunakan model Tobin Q sebagai proksi untuk prestasi firma. Sebanyak 220 syarikat dipilih dari senaraian Bursa Malaysia Kuala Lumpur (BSKL) yang tertumpu pada papan utama bagi tahun 2003. Hasil kajian ini, mendapati bilangan pengarah bebas bukan eksekutif tidak menyumbangkan terhadap prestasi firma. Kajian ini juga menunjukkan semua syarikat mematuhi aras pematuhan iaitu satu pertiga daripada lembaga pengarah terdiri daripada pengarah bebas bukan eksekutif yang ditetapkan oleh keperluan penyenaraian BSKL. Keputusan ini dianggap memuaskan. Dengan menggunakan analisis regresi cebis demi cebis, keputusan menunjukkan bahawa perhubungan di antara pemilikan syarikat dan prestasi firma adalah tidak linear. Walau bagaimanapun, kesan interaksi di antara bilangan pengarah bebas bukan eksekutif dan pemilikan pengurus syarikat tidak menunjukkan signifikan terhadap prestasi firma.

Chapter 1

INTRODUCTION

1.1 Introduction

This chapter introduces the research outline of the study. The chapter illustrates the background of the study, problem statement, research objectives and questions, significance of the study and organization of the remaining chapters.

1.2 Background

Leung and Horwitz (2004) argued that the failing of corporate governance and lack of transparency are often associated with the Asian financial crisis. Public listed companies in Malaysia like other Asian firms have concentrated managerial ownership. Thus, the burden and responsibility fall on the board of directors to enhance and drive the company towards success. The corporate governance studies also highlight the composition of board of directors as an important aspect in protecting the interest of shareholders, especially in transactions where the interest of managers and outside shareholders may depart.

Aligned with these objectives, the Malaysian Code on Corporate Governance (2001) requires at least one-third of a board to comprise of independent directors. In addition, it stipulates that independent directors take the lead in certain board committee. This is why independent directors have a pivotal role in the Malaysian corporate sectors. These directors are expected to look after the interest of the minority shareholders, which requires vigilance, integrity and good understanding of how business works (The Star, 2004). As such, they ought to be top-notch managers so as to be able to pass the often intense shareholder scrutiny. Yet, this is not so in practice.

On the other hand, managerial ownership plays an important role in the corporate governance literature. The responsibility of running the company is the duty of the company's CEO and its board of directors. However, the recurring criticism is that many corporate management often do not behave in the manner consistent with the shareholder's objectives. Unfortunately, some management may act more in their own interests than in those of the shareholders. It has been recently suggested that the board's control over management should ensure the company's success. However, the board's lack of independence impedes that intention.

1.3 Problem Statement

This study tries to investigate how the independent non-executive directors and managerial ownership enhance firm performance. The board of director's vital contribution is to monitor and screen management decision. In consequence to that, it is imperative to have outside directors, chiefly independent director on the board to secure better monitoring of the board and eventually containing managerial opportunism (Fama, 1980; Fama & Jensen, 1983 as cited in Eng & Mak, 2003). The question arises as to why we need outside directors on the board? Research done by Rhoades, Rechner and Sundramurthy (2000) found that outside directors have better influence over management and conflict of interest as compared to inside directors. This is mainly because they are financially independent, have an aptitude to isolate management and decision making process. Daily, Johnson and Dalton (1999) added that inclusion the of outside directors are more likely to support the interests of shareholders and to execute monitor and control functions, as well as replacing the CEO, reviewing managerial decision and performance.

Byrd and Hickman (1992) stated that both inside and outside directors have their own strengths. Insider directors provide specialized knowledge and valuable information for the daily company operations, while outside directors may add both expertise and objectivity in assessing the manager's decisions. The corporate board, with the mix of expertise, independence, and legal power, is a potentially powerful governance mechanism. Thus the existence of outside directors (independent) in the board will enhance better performance.

A number of empirical researches have been done on the relationship between governance mechanisms. One line of research examines the empirical relationship between managerial ownership and firm performance (Akimova & Schwodiauer, 2004; Davies, Hillier & McColgan, 2002; Demsetz & Villalonga, 2001; Morck, Shleifer & Vishny, 1988). Other studies on corporate governance attributes includes the proportion or existence of independent directors and firm performances (Peng, Buck, & Filatotchev, 2003; Weir & Laing, 2001; Clarke, 1998; Forker, 1992 & Fosberg, 1989) Even so, studies have also been done between managerial ownership and outside directors towards firm performance (Peasnell, Pope, & Young, 2001; Faccio & Lasfer, 2000; Barnhart & Rosenstein, 1998; Mallette & Fowler, 1992).

In the Malaysian literature, studies have been conducted on the direct relationship between board structure and ownership structure towards firm performance. To our knowledge, no study has looked into the perspective of interaction between independent non-executive director and managerial ownership towards firm performances, particularly in Malaysian context. Therefore, this study investigates whether the interaction between managerial ownership and independent non-executive directors has any impact on the firm performance.

1.4 Research Objectives

Therefore, this study attempts to accomplish four main objectives as follows:

(1) To determine whether the proportion of independent non-executive directors on corporate board influence firm performance.

(2) To examine whether managerial ownership influence firm performance.

(3) To examine the proportion of independent non-executive directors and managerial ownership on firm performance.

(4) To investigate the interaction effects between independent non-executive directors and managerial ownership on firm performance.

1.5 Research Questions

In order to achieve the above mentioned objectives, this study will try to answer the following research questions;

(1) Whether the higher proportion of independent non-executive directors on corporate boards has an impact on firm performance?

(2) Whether managerial ownership structures have an impact on firm performance? (non-linear relationship)

(3) Whether the higher proportion of independent non-executive directors and different levels of managerial ownership have an impact on firm performance?

(4) Whether the interaction effects between the higher proportion of independent non-executive directors and different levels of managerial ownership have an impact on firm performance?

1.6 Definition of Key Terms

Before further discussion, it is necessary to redefine terms used throughout the study. It will be pertinent to share a common understanding of the concepts such as financial performance, independent non-executive directors, and the managerial structures.

1.6.1 Financial Performance

The Tobin's Q is a measure of market performance and computed as (market value of equity + total liabilities) divided by total assets.

1.6.2 Independent Non-Executive Directors

Stock Exchange of Hong Kong Limited define the independent non-executive directors as directors who do not have the administrative or management responsibilities in a company, without any direct relations which could interfere with the exercise of independent judgment with the management and do not have any interests other than the remuneration paid by the company.

1.6.3 Managerial Ownership

Managerial ownership is measured as the proportions of director's equity ownership as proxy for managerial share ownership, which includes their deemed interest.

1.7 Significance of Study

This study is important since it will help to provide feedback to PLCs on how to improve the quality of boards. Besides, the emergence of AFTA and globalization is a challenge to PLCs in Malaysia to plan and prepare to compete with international companies. For this reason PLCs need to strengthen their corporate governance in order to be standardized with the international corporate governance.

This paper will contribute to both theory and practice in the area of corporate governance. Agency theory enhances the interests between the managers and shareholders to raises firm value. On the other hand, regulatory bodies, practitioners, shareholders, and managers will benefited with up-to-date information, particularly in the area of board effectiveness, its impact on the firm performance.

Appointing independent directors will tap a reservoir of talent and skills that will enhance the level of corporate governance in Malaysia and in improving the performance of Malaysian companies. Their experience and expertise, both are in a position to add considerable value to the company. Additionally, independent directors bring diversity and breadth of experience to the operation of a company board and to enhance the formulation of strategy and its execution.

Besides, understanding the existence of independent directors in managerial ownership structures will shed light on the governance and control process of firms. This study will help and provide better understanding of the independent directors and managerial ownership in Malaysian companies. It is also hoped that the findings of this study would contribute to the literature of independence of boards' effectiveness and managerial ownership. Finally, this study might help policy makers to improve corporate governance structure in Malaysian context.

1.8 Organization of Remaining Chapters

This study is structured mainly in five chapters with chapter one on introduction of the study as well as overview of the study. Chapter two reviews the literatures which outlines previous research undertaken in relation to independent non-executive directors, managerial ownership and firm performances. The data and variables section which discusses the sample and defines the variables will be presented in chapter three. The result section in chapter four will argue the empirical analysis of the sample and will test the hypotheses. Finally, chapter five illustrates the discussions and conclusions of the study.

Chapter 2

LITERATURE REVIEW

2.1 Introduction

In order to obtain a better understanding of this study, a comprehensive search of the past literature reveals that several studies have been undertaken to examine the relationship between independent non-executive directors and managerial ownership towards firm performances. This chapter discusses several issues, namely, independent non-executive directors, managerial ownership and firm performances.

2.2 Literature Overview

The subject of corporate governance became fashionable in the last decade of the 20th century and gathered within its parameters manifold issues relating to corporate and company law. The Cadbury Report (1992) defines corporate governance as systems in which companies are directed and managed. More specifically in the 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".* (pg. 10)

Selected committees, comprising distinguished personalities, have already issued comprehensive reports on the subject in Britain, Australia, South Africa and Canada. The Cadbury, Hampel, Bosch, Day and King Reports are samples (Thomas, 2002). In Malaysia, the High-Level Finance Committee issued a detailed report on the subject in February 1999. Later, in March 2000, the Finance Committee released the amended Malaysian Code on Corporate Governance. Indeed, one of the amended codes is clarifies and enhances the definition of independent directors.

Daily and Dalton (2003) stated 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"* (pg. 41). As such, much of the debate on corporate governance centres on the responsibilities that businesses have and owe to the community. The two-holds on independent non-executive directors as business advisers and watchdogs need to be seen in balance. This is particularly important as greater understanding is to be achieved and independent non-executive directors are engaged throughout listed companies.

Li (1994) stated that for a corporate board to be powerful governance, the tools of expertise, independence and legal power must be intrinsic in its structure. Therefore, the Finance Committee (1999) recommends that Malaysian quoted companies that have one-third of board should comprise independent directors. This, it was believed, would provide sufficient numbers to generate independent views that influence a board's decisions. Independent directors have a vital role to play in both monitoring the performance and conduct of executive management, and in contributing to the strategic direction of a company.

It is now widely accepted that independent non-executive directors have an important part to play in the proper running of the boards of listed companies. Furthermore, their contribution to the board's deliberations has also become an area of keen interest for researchers.

2.3 Agency Theory

Good corporate governance should enable owners to exercise control over management (e.g Jensen & Meckling, 1976; Fama & Jensen, 1883; Eisenhardt, 1989, as cited in Randoy & Goel, 2003). This is made clear by Jensen and Meckling (1976) in their agency theory which highlights the inherent conflict in interest between the owners (principal) of a company and its management (agent). This conflict occurs when the agent responds to incentives, and will not always act in the best interests of the principal. The agency theory thus emphasizes that managers of firms conduct businesses following ethics that are in the best interests of their shareholders (owners) (Othman, 2003).

Weir's (1997) suggestion that an effective board of directors can protect shareholders' interests is actually an important form of check and balance. An efficient board that ensures effective top management will thus stimulate shareholder wealth and earnings that are comparable to the earnings of shareholders to the shareholders of similar firms. Clearly, appropriate internal control and monitoring mechanisms are essential to foster shareholder wealth.

To ensure good 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. Hence, well aligned and successful monitoring mechanisms will therefore improve the company's performance. Nevertheless, not only will discretionary activities diminish but shareholders' returns will increase (Weir, 1997). On the basis of this evaluation, the existence of independent non-executive directors on the board will reduce agency cost and enhance independent judgment on the corporate board.

2.4 Determinants of Boards' Independence

According to PricewaterhouseCoopers (2000), a board's composition is fundamental to its effectiveness. Boards need to have a degree of independence from management, have the right people at the table and be of manageable size to function well. Fama and Jensen (1983) maintain that outside directors are effective monitors of management because of strong need to keep intact their reputation as good, independent decision makers. The Finance Committee (1999) recommended that boards of listed companies be comprised of one-third of independent non-executive directors with no fewer than two outsiders. The 'green book' defines the term "independent" under rule 9 of the Listing Requirements as follows –

> *"The composition of the board of directors should reflect the ownership structure of the company. Every listed company should have independent directors, that is, directors that are not officers of the company; who are neither related to its officers nor represent concentrated or family holdings of its shares; who, in the view of the company's board of directors, represent the interest of public shareholders, and are free of any relationship that would interfere with the exercise of independent judgment ".* (FCCG, pg. 82)

According to Lechem (2003), an independent director should be independent from management and free from any relationship which could interfere with the exercise of independent judgment. Matolscy, Stokes and Wright (2004) support this stand. They state that corporate governance would weaken if inside directors dominated the board. However, stronger governance would prevail if a board is dominated by outsiders as outside directors do not depend on the CEO for their future income. In fact, because outside directors have the additional role of monitoring governance, they can replace weak links of senior management, particularly the CEO.

2.5 Why the Argument over Independence?

Weir et al. (2001) claimed that non-executive directors must be are independent directors if there is to be effective monitoring. Therefore, any non-executive directors who is, for example, a retired ex-director or those who work for a firm that provides service to the company cannot be considered independent non-executive directors.

Moreover, O'Sullivan and Wong (1999) stated that non-executive directors who have served many years on the same board can become less effective as they tend to establish close relations with executive directors. This supports Cadbury's claim that a non-executive director's independence may diminish as his board tenure increases.

Finally, non-executive directors cannot be effective in their monitoring role it they are not independent and unable to exercise independent judgment. This will be especially possible if an executive director becomes a non-executive director of the same company after retirement (Weir et al., 2001). Thus, the presence of non-executive directors on a board cannot be regarded as giving some form of guarantee of either performance or absence of fraud. On the other hand, Eng et al. (2003) have suggested that outside directors who are not so close to management are capable of encouraging firms to disclose more information to outside investors. As such, it is important to have independent non-executive directors on the board to evaluate and enhance better performance.

2.6 Ownership Structure in Malaysia

According to La-Porta, Lopez and Shleifer (1999), Malaysian firms were highly concentrated. By and large, the owners were also usually the directors of the company (Cheah & Chu, 2004). Thillainathan (1999) also identified concentration in ownership in Malaysia. Moreover, Cheah et al. (2004) added with this large shareholder structure, it often allows cross holdings and pyramid structure to exist and controls other firms without high financial outlays.

In the Malaysian perspective, shareholding in Malaysian PLCs is concentrated by different structures namely, family, state, widely held financial institutions and corporations, foreign institutions and of course blockholder and managerial ownerships. According to Thillainathan (1999), 85 percent of the PLCs had owner-managers in that the post of the CEO, Board Chairman or Vice Chairman were either a member of the controlling family or an employee drawn from the ranks of the controlling shareholders.

2.7 Independent Non-Executive Directors and Performances

Ghosh and Sirmans (2003) suggested that one important mechanism designed to reduce agency problems is the appointment of independent directors on the corporate board. Both empirical and theoretical analyses suggest that outside members on the board of directors serve a critical role in the monitoring and disciplining of senior managers, and thereby influencing firm performance. Fama et al. (1983) also contend that monitoring managerial opportunism become more effective with a higher proportion of outside directors.

There have been a number of studies which analyze the relationship between independent directors and firm performance. It is arguable that the overall role of independent non-executive directors is to monitor the management. Thus, the proportion of independent non-executive directors on a board should be positively related to firm performance.

However, the empirical evidence shows a mixed relationship. Laing and Weir (1999) noted that board comprising a majority of non-executive directors does not necessarily result in better performance as compared to executive directors dominating the board**.** There is no evidence that shows increased non-executive director representation results in increased on firm performance. This finding is also supported by Fosberg (1989), who found that there was no relationship between the POD (proportion of outside directors) and the various variables used to gauge managerial performance (return on equity, average return on equity, sales). It also put forth that there are no significant differences between the mean value of return on equity of firm with, or without, POD. However, Bhagat and Black (2000) also have supported evidence that the result shows that firms suffering from low profitability respond by increasing the independence of their board of directors.

In the Malaysian context, research carried by Abdullah (2004) and Othman (2003) found a negative relationship between the board's independence and firm performance. Using data 1994-1996, Abdullah (2004) found that the board's independence and the CEO's duality, either singly, or jointly, did not relate to firm performance. A similar study done by Othman (2003) found the relationship between the number of independent non-executive directors on the board and return on asset (ROA) showed negative but insignificant signs.

On the other hand, Schellenger, Wood, and Tashakori (1989) in their study found a direct and positive relationship between independent non executive directors and corporate financial performance. Also their findings indicate that the presence of independent non-executive directors on corporate boards enhanced the firm's market performance. Similarly, Hutchinson (2002) found that a higher proportion of outside directors on the boards of high growth firms are associated with the firm's higher performance based on the accounting rate of return on equity measure.

Moreover, Taub (2004) and Uzun, Szewczyk, and Varma (2004) reveal that the higher proportion of independent outside directors is associated with less likelihood of corporate wrongdoing. Besides, Chen and Jaggi, (2000) also found a positive relationship between the proportion of independent non-executive directors and comprehensiveness of financial disclosures. They believe that independent directors are essential to monitor the boards' activities, and to improve the transparency of corporate boards.

A recent study by Bonn (2004) on board structure and firm performance revealed that the proportion of outside directors on the board is positively associated with the firm's performance. The results of the study suggest that outside directors can effectively monitor and influence the management. Moreover, Rosenstein and Wyatt (1990) also contend that the firm's value increased if outside director were included to the board improved the firm's value. Baysinger and Butler (1985) concede with this as they have evidence shows that firm's performance increased if more outsiders were included in the board. In the Malaysian context, none of the studies has so far looked into the relationship between independent non-executive directors and firm performance after the amendments of one-third of board consist independent directors by the Malaysian Code on Corporate Governance (2001). Again, existing independent directors will monitor better to improve the transparency of corporate boards and subsequently influence firm performance. Therefore, based on the above arguments, the higher the proportion of independent non-executive directors on the corporate board will result in the greater firm performance.

2.8 Managerial Ownership and Performances

Managerial ownership plays an important role in the corporate governance literature. Previous studies reveal that managerial ownership influences a firm's performance (Barnhart et al., 1998; Han, Lee & Suk, 1998; Agrawal & Knoeber, 1996). Chen (2001) has supported evidence that the management ownership variable has a positive coefficient in the corporate performance regression. Companies that are totally owned by managers do especially well. Taking into account that a relatively small proportion of shares are held by the management, it is possible that raising such a proportion might significantly strengthen the management's incentive to improve the firm's performance.

However, empirical evidence on the relationship between managerial ownership and firm performance is mixed across nations. Interestingly, the nonlinear relationship between managerial ownership and firm performance (Tobin's Q) is well accepted. Mueller and Spitz (2001) propound that managerial ownership shares up to around 80 percent render a positive effect on a firm's performance. However, negative effects take place thereafter. Hermalin and Weisbach (1991) also posit evidence that at managerial levels less than one percent, the Tobin's Q increases with ownership. But a level greater than 20 percent, Tobin's Q decreases with ownership.

The studies by Morck et al. (1988) also posited similar evidence as above. They found positive and negative relationships between managerial ownership levels and a firm's values. The positive effect reflects the convergence of interest effect. As managerial equity increases, managers are likely to coincide more closely with those outside shareholders' interests. As ownership increases beyond certain levels, there are negative effects on the firm's value; this reflects an entrenchment of interest effect. Here, the managers tend to be entrenched, as they are less interested in the welfare of their shareholders.

Leung et al. (2004) found similar evidence concerning director ownership and voluntary segment disclosure. In the study showed that voluntary segment disclosure increases as director ownership increases from 1 percent to 25 percent. However, the disclosure decreases as ownership rises above 25 percent as a result of conflict of interest between the controlling and minority shareholders. Therefore, at a high level of managerial ownership, the alignment is attenuated and the agency problem moves from the managers/ shareholders.

In the Malaysian studies, local researchers found similar evidence. Mat Nor, Said, and Redzuan (1999) using cross section data, stated Tobin's Q, earnings per share (EPS) and price earnings ratio (P/E) increase for the board ownership range of 0 percent and 5 percent, decrease as ownership rises between 5 percent and 25 percent, (statistically significantly for Tobin's Q, and P/E), and then continues to increase (expect for P/E) as board ownership increases beyond 25 percent. This evidence is also supported by studies done by Ali and Sanda (2001). They established that ownership significantly influenced performance, increasing at early levels of board ownership and decreasing at the levels of ownership beyond 36.7 percent of a firm's equity. Hence, this study expects to show that there is a non-linear relationship between managerial ownership and firm performance.

2.9 Board Composition, Managerial Ownership, and Firm Performance

Internal control in public companies is delegated by shareholders to a board of directors, although generally they retain approval rights over such matters as board memberships. The board then delegates most decision management and control functions to internal agents. Agency problems arise when decisions are made which are inconsistent with shareholders' interests. These problems are addressed in the governance structure by separating decision management (initiation and implementation of decisions) and decision control (ratification and monitoring of decisions). Decision control is the corporate boards' primary function, and outside director have the particular responsibility of advocating shareholder interests.

Previous research documented that relationship between managerial ownership and board composition is essential in corporate governance structure. A number of empirical studies show some argument over the relations between managerial ownership and board compositions towards firm performances.

Weisbach (1988) put forth that the relationship between managerial turnover and performance is stronger within companies with outsiders-dominated boards. His findings recognize the importance and monitoring effectiveness of outside directors. Rosenstein and Wyatt (1997) suggested that in the moderate inside ownership level (5 percent- 25 percent), where inside ownership reduces agency problem between manager and outside shareholders, it appears that the balance of inside and outside directors is essential, with a new insider more valuable than an outsider-dominated board. They added that managerial ownership dominated board composition is an effective tool for aligning managerial and shareholder's interests. Denis and Sarin (1999) particularly emphasized that inside ownership is conversely correlated to the proportion of outside directors. Consequently, the effectiveness of outside directors monitoring the board is depends on the degree of managerial ownership levels.

Brickley and James (1987) advocate that outside directors in the banking industry tend to decrease managerial consumption of perquisites. Peng et al. (2003) has also established in their study that when outsider directors interact with supervisory and/or executive board(s) and a new CEO, it affects performance positively. Therefore, if the boards are effective in controlling agency problems and ensuring that management decisions are consistent with enhancing shareholder value, this should result in better corporate performance.

However, it is likely for high managerial ownership firms to have weaker board independence. According to Leung et al. (2004), when managerial ownership is higher, the controlling owners will have more voting power or influence to decide on structure of the outside directors on the board. Consequently, this will be significant in appointing independent non-executive directors. Clearly, the preceding discussions imply that the proportion of independent non-executive directors in many managerial ownership levels effect performance. This leads to the final hypothesis, the interaction effects between the higher proportion of independent non-executive directors and different levels of managerial ownership have an impact on firm performance**.**

2.10 Dependent Variable

The dependent variable is the firm's performance. Based on the literature review, Tobin's Q is the most commonly used performance measures.

2.10.1 Tobin's Q

The Tobin's Q is a measure of market performance and computed as (market value of equity + total liabilities) divided by total assets. The Q ratio was used as a measure of managerial performance on the basis that well-managed companies that make profitable investment should have Q ratios greater than 1, while poorly managed companies are likely to have ratios less than 1 (Peirson, Brown, Easton, & Howard, 2003). This measure feasible with cross sectional data instead of time series, as inflation greatly influences the approximation of total assets' replacement costs (Chen, 2001). This measurement approach is similar to Cheah et al., (2004); Welch (2003); Chen (2001); Barnhart, Marr and Rosenstein, (1994) and Morck et al. (1988) who examine the relationship between governance structure and firm performance.

2.11 Control Variables

To better examine the effects of independent non-executive directors and managerial ownership on firm performance, the study used control variables namely, firm size, leverage and board size that may affect the firms' performance. By controlling these variables, it is believed that there is some impact on the relationship between independent non-executive directors and managerial ownership on firm performance. This study used three control variables because previous studies proved that these variables significantly affect the firm's performance.

2.11.1 Firm Size

Firm size has long been accepted in corporate governance research. This study uses the natural logarithm of total assets as proxy for the size of a firm as in Chen, 2001; Barnhart et al. (1998); and Hermalin et al. (1991). A number of empirical literatures have investigated the relation between size and firm performances. The inclusion of firm size as a control variable in this study is provoked by the fact that it has been found to be related with various firm characteristics. Lang and Stulz (1994) find a negative correlation between firm size and Tobin's Q. Himmelberg, Hubbard and Palia (1999) propound that the larger firm suffers greater monitoring and agency costs. Besides, larger firms tend to employ more skilled managers, who become wealthier. This indicates a higher level of managerial ownership. In addition, large firms accrue the potential economies of scale and scope (Bonn, 2004).

2.11.2 Leverage

This study uses long-term liability divided by total assets as a proxy of leverage level. According to Othman (2003), this ratio indicates how firms choose to finance operations. Thus, the lower the ratio, the greater the protection for lenders, who rank before shareholders. According to Whited (1992), small firms cannot avail themselves to long-term debt markets since their growth will be more than their collateralizable assets. Moreover, Titman and Wessels (1988) assert that capital structure is easily accessible to larger firms. Morck et al. (1988) contend that managers from the more influential firms may hold a slightly high equity for the same Tobin's Q. Welch (2003) further propound that firm influence lead to a measure of monitoring by credit providers. This may decrease the need for additional monitoring granted by concentrated ownership. Agency theory foresees that the board's effectiveness would grow as the extent of leverage rises. This in turn would increase the firm's performance.

2.11.3 Board Size

Yermack (1996) used board size as a measure of board cohesiveness. Board size is measured as the total number of directors on the board. Usually, larger firms tend to have larger boards, compared to small firms. Studies done by Lipton and Lorsch (1992); Jensen (1993) and Yermack (1996), found an inverse relationship between board size and firm value. They found firms achieve highest market value when boards are small. Bone (2004) proffers that boards with small numbers will probably agree on outcomes and engage in actual interaction and debate. However, larger boards will face a lack of cohesiveness, coordination difficulties and fractionalization which will result serious consequences. Moreover, Matolcsy et al. (2004) emphasized that companies with larger boards can better counteract the effects of poor decision-making by surmounting the partiality against high-risk projects. Conversely, companies with smaller boards are likely to gain more profit. Therefore, board size can affect the value-relevance of outside directors.

2.12 Theoretical Framework

Theoretical framework of the study is shown in Figure 2.1. The study proposes that proportion of independent non-executive directors and managerial ownership will influences firm performances. In addition, the study also examined whether the interaction between the proportion of independent non-executive directors and managerial ownership will have an impact on firm performance. Firm size, leverage and board size will serve as control variables. The above relationships are depicted in a schematic diagram as given below;

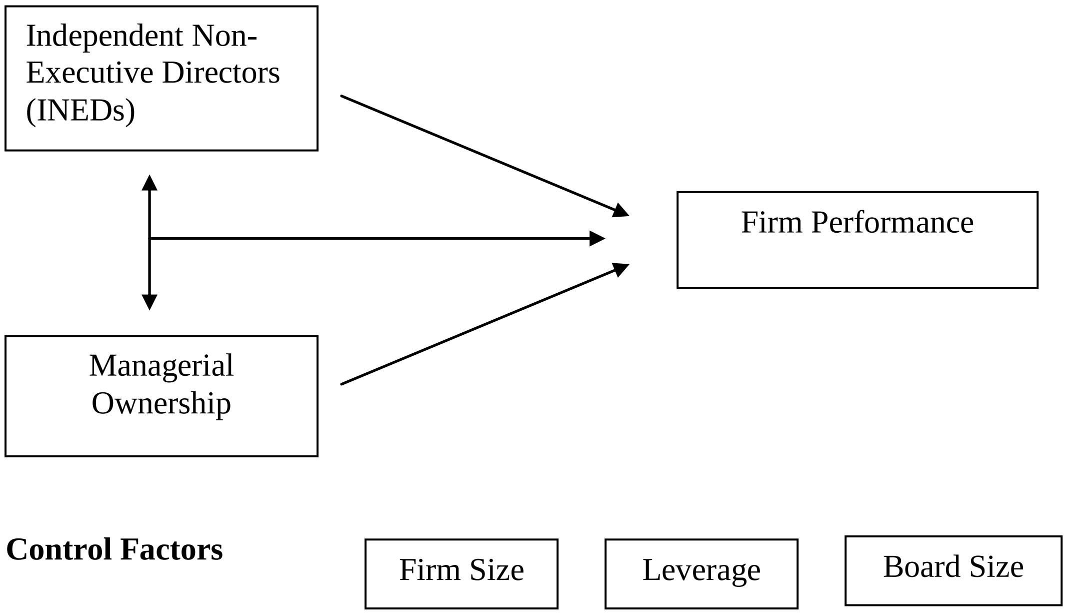

Figure 2.1: Theoretical Framework

2.13 Hypotheses Development

The hypothesis development in this study is based on the agency theory framework. Theoretically, boards of directors consists insider and outside directors are argued to play a vital role in influencing firm's performance. Nevertheless, pervious findings show mixed results of positive and negative relationships between independent non-executive directors and managerial ownership towards firm performance. In this study, four hypotheses are constructed. This will be explained as followings.

2.13.1 Independent Non-Executive Directors

Having an independent director on the boards will enhance the effectiveness of monitoring function and ensure that management is not running the company for their own personal interest. However, previous researches, found a mixed relationship between independent non-executive directors and firm value. Abdullah (2004); Othman (2003); Bhagat et al. (2000) and Fosberg (1989) found negative relationship between the board of independence and firm performances. On the other hand, studies by Bonn (2004); Hutchinson, (2002); Rosenstein et al. (1990); Schellenger et al. (1989); and Baysinger (1985) found inclusion of independent directors improved the firm's value. Thus, existing independent directors will be better monitoring and enhance firm performance. Therefore, based on the literatures, it is hypothesize that:

Hypothesis 1: *The higher the proportions of independent non-executive directors on corporate board, the greater the firm performance.*

2.13.2 Managerial ownership

Study done by Jensen et al. in 1976 found the firm value is positively correlated with the level of managerial ownership. However, Mueller et al. (2001); Hermalin et al. (1991); Morck et al. (1988) and Wong et al. (1991) in their studies show that the relationship between firm performance and managerial ownership is not linear. Similar evidence reported by Ali et al. (2001) and Mat Nor et al. (1999) in Malaysian scenario. Therefore, it is hypothesize that:

Hypothesis 2: *There is a non-linear relationship between managerial ownership and firm performance.*

2.13.3 Board Composition and Managerial Ownership

Previous study has recognized that relationship between managerial ownership and board compositions is vital in corporate governance structure. A number of empirical studies show some argument over the relations between managerial ownership and board compositions towards firm performances. Rosenstein et al.