

# Board Effectiveness, Managerial Ownership and Company Performance

Aza Azlina Md Kassim<sup>1</sup>, Zuaini Ishak<sup>2</sup> and Nor Aziah Abdul Manaf<sup>3</sup>

<sup>1</sup>*Faculty of Business, Universiti Selangor, Aza\_Nana@hotmail.com*

<sup>2,3</sup>*College of Business, Universiti Utara Malaysia*

## ABSTRACT

The study examines the effects of board process and managerial ownership on company performance of Malaysian public listed companies. Unlike traditional governance models that emphasize on board structure, this study focuses on board process. Two types of data are used; a survey to Malaysian directors and company annual reports. In total, 175 companies responded to the questionnaires, which represent 26% of response rate. The results of the study provide evidence that board's risks oversight and performance of independent directors are associated to company performance. The results provide feedback to the policy makers in Malaysia as the results indicate that board effectiveness influences company performance.

**Keywords:** Risk oversight, accessibility of information, independent directors.

## I INTRODUCTION

Directors are persons appointed or elected according to the law. The whole of directors collectively, form the board of directors. The board of directors is expected to monitor the management decisions and protect the shareholders' interests as well as the company as a whole. However, shareholders are under disadvantage if the decision turns out to be inefficient and very risky due to poor monitoring by the directors (King & Wen, 2011). The study aims to determine the effect of board process and managerial ownership on company performance. This paper is organized as follows. In section II, the interrelationships between company performance and corporate governance mechanisms; board process and managerial ownership are provided. Section III discusses the research methodology and data collection. The results are presented in section IV. The discussion

and conclusion remarks are set out in the final section.

## II LITERATURE REVIEW

Board process is the way directors discharging their duties in steering the board (Macus, 2008) and reflection of decision making activities. This study incorporates four pertinent variables as the proxy of board process namely board's risks oversight, accessibility of information, Chief Executive Officer (CEO)'s performance evaluation and performance of independent directors.

**Board's risks oversight:** A business risk relates to the inability of a company to predict the future performance in uncertain environment (Sobel & Reding, 2004). The board roles in risk management are very important so as to ensure that the company will survive in uncertain economic condition. Therefore, board should regularly question the management on risks that they perceive the company will be facing (Raber, 2003). Sobel and Reading (2004) argue that board must actively involve in risk management process by providing expertise and judgment to the strategic process. In addition, the senior management should be given the autonomy to manage the risks within the accepted risk tolerance by the board. Apparently, the director's ability in analytical thinking skills and strategic perceptions are important in risk management and these criteria have influence on company performance (Kula & Tatoglu, 2006). Therefore, this study assumes that board that evaluates current and future risks of the company provides a positive impact on company performance.

**Accessibility of information:** Directors must have sufficient access to information in order for the board to function effectively. Hence, directors must ensure that they are given relevant materials which

will be discussed in the meeting by the management or company secretary. Having more access to information allows directors to improve their problem solving ability during board deliberation (Macus, 2008), provide constructive arguments (Zahra & Pearce, 1989) and enhance their accountability to the shareholders (Kula, 2005). Therefore, the directors' ability to get access to company information is expected to have effect on company performance.

**CEO's performance evaluation:** Performance evaluation is a process of managing performance in which it incorporates regular evaluation, feedback and counseling (Gomez, 2010). Agency theory supports that management as well as the CEO's actions and decisions should be monitored and evaluated by the board (Jensen & Meckling, 1976). The process is crucial as it influences the decisions that relate to promotions, transfers or terminations of the CEOs. Further, the evaluation provides feedback to CEO on how company views their performance (Robbins & Judge, 2009; Dulewicz & Herbert, 2004).

The MCCG also recommended that every board member including the CEO need to be assessed. Therefore, the CEOs are more likely to put extra attention on decision making process as their performance will be accessed through the outcome of their decisions. Hence, this study expects a positive relationship between CEO's performance evaluation and company performance.

**Performance of independent directors:** The agency perspectives support the view that the greater the proportion of outside directors is essential for effective monitoring of management performance and self-interest actions. Besides, the management decisions must be monitored vigorously by the board to avoid any expropriation of minority interests (Baysinger & Butler, 1985). Effective independent directors with the ability to understand the company business, provide unbiased judgment and bring in practical ideas based on their professional experience during board deliberation are able to improve company performance (Yeap, 2009; Hasnah & Hasnah, 2009). In addition, independent directors with the capability in communicating with those people who involve directly in the decision making are more likely to get update on any major events that

have detrimental effects to the company such as example bankruptcy, merger or any changes in regulations (Finkelstein & Mooney, 2003). These positive attitudes of effective independent directors are able to contribute to positive company value.

**Managerial ownership:** In Malaysia, insider shareholdings are very common (Haniffa & Hudaib, 2006). The owners are normally appointed as the managers (Mazlina & Ayoib, 2011). High levels of managerial ownership allow the owners-managers to participate actively in the decision making process. Besides, they have high motivation to bring more profits into the company (Jensen & Meckling, 1976). Such mechanism enables the interest of shareholders to be protected (Harris & Raviv, 2008). Therefore, the study assumes that company with high managerial ownership is expected to have a positive effect on company performance.

**Control variables:** Larger companies are able to establish various diversifications in business and remain stable cash flow. The accesses to capital markets are also easier for large companies. However, companies that have established in the market for a long period tend to become more conservative in the strategies, therefore, affect company performance. Meanwhile, companies with high level of leverage are unable to invest in profitable projects, thus, such situation affects company performance. Therefore, three variables; company size, age and leverage are included in the analysis. The variables are expected to have influence on company performance.

### III RESEARCH METHODOLOGY

#### Sample size and data collection

The study was conducted on companies listed on main market of Bursa Malaysia as at 31 December 2009. The study combines a survey approach and secondary data. For survey approach, the questionnaires were disseminated to the company chairman, independent director, executive director and non-independent non-executive director in order to get a balance directors' perception on board process. Once the researcher received the completed questionnaire, it will be matched with the secondary data for that particular company. The

information of managerial ownership, company characteristics and performance were extracted from the annual report of 2007 to 2009. From 687 companies (after excluding companies which were listed under financial sector, new companies listed in 2007, 2008 and 2009 as well as PN17 and Amended PN17 companies) a total of 175 companies (27 per cent) participated in this study.

### Construction of questionnaire and measurement of variables

The questionnaire was developed based upon the literatures and inputs from two risk specialists and an executive chairman of a committee from regulatory bodies and three public listed directors. Besides, the items in the questionnaires were adapted from MCGG, Carey, Patsalox-Fox and Useem (2009), Wyman (2009), Ingley and Van der Walt (2005), Epstein and Roy (2005), Sang-Woo and Il (2004), Sobel and Reding (2004), Dulewicz and Herbert (2004), Raber (2003), Finkelstein and Mooney (2003) and Taylor, Tracy, Renard, Harrison and Carroll (1995). Four proxies of board process namely board's risks oversight, accessibility of information, Chief Executive Officer (CEO)'s performance evaluation and performance of independent directors are used in the study.

There are six items on demographic information and 31 items on board process. The questions on board risks oversight, accessibility of information and CEO's performance evaluation are designed to

measure the degree of directors' agreement using 5-point scales ranging from "1" as strongly disagree to "5" as strongly agree. In relation to the performance of independent directors, the statements were measured using a Likert-scale ranging from very "1" as very poor to "5" as outstanding. Higher scores indicate higher level of independent directors' performance. Company performance is proxied by return on equity (ROE). The ratio is determined by dividing net profit to the average common shareholders' equity. Managerial ownership refers to the proportion of shares own by all executive directors to total outstanding shares (Mazlina & Ayoib, 2011). For the purpose of analysis, companies with at least 5 per cent of executive directors' shareholdings were coded as 1, otherwise 0. In addition, the total asset is used as proxy for company size. Company age is measured by referring to the year of listed and it is subtracted with the date of financial year end in 2007, 2008 and 2009. Meanwhile, company leverage is measured by dividing total debts to total assets.

## IV RESULTS

Table 1 presents the results of factor analysis. Internal reliability test indicates strong Cronbach Alpha values from every factor ranging from 0.722 to 0.935. Meanwhile, table 2 provides descriptive statistics of board process attributes managerial ownership, company characteristics and performance.

Table 1. Factor analysis

	Eigen value	Cumulative	Alpha
<b>Factor 1: Performance of independent directors</b>	12.720	19.067	0.935
Ability to provide strategic vision	0.775		
How effective the independent directors represent the interest of shareholders?	0.757		
Relationship with senior management	0.696		
How effective the independent directors represent the interest of stakeholders?	0.688		
Understanding on company business	0.677		
Contribution in board committees	0.650		
Record of constructively challenging and debating issues during board meetings	0.650		
Relationship with the CEO	0.601		
Ability to apply his or her industries experience	0.601		
Interactive communication of independent directors with other board members	0.536		
<b>Factor 2: CEO's performance evaluation</b>			

Board communicates to the CEO on his/her success based on the evaluation result	0.835	3.09	36.385	0.925
Board evaluates CEO by using KPI	0.786			
Board establishes an exit mechanism which is tied up with CEO's performance	0.737			
Board implements a reward system which is based on long term performance	0.724			
Board communicates to the CEO on his/her failures based on the evaluation result	0.721			
Board provides avenue for CEO to explain on the state of CEO's performance	0.712			
Board communicates their expectations clearly to the CEO	0.708			
Board accepts feedback from CEO during the process of setting KPI	0.677			
<b>Factor 3: Board's risk oversight</b>		1.99	52.309	0.911
Board requires senior management to deliberate on emerging risks that the management perceived the company will be facing	0.789			
Board gets update from senior management on risk management matters	0.731			
Board raise concern on risk management	0.712			
Board communicate on risk tolerance to senior management	0.699			
Board attends relevant risk management training	0.678			
Board reviews its strategy during crisis	0.648			
Members of board ask the senior management to use scenario analysis in identifying potential vulnerabilities	0.614			
Board has necessary financial knowledge to analyze the financial statement	0.584			
<b>Factor 4: Accessibility of information</b>		1.89	63.501	0.722
Directors discuss issues thoroughly	0.830			
Directors have access to information via managers	0.816			
At time where directors need to refer to company business records and books, their access is denied	0.726			
When outside professional services is needed, the expenses will be borne by the company	0.726			
Directors received sufficient materials/ information before board meetings	0.759			

Note: K-M-O measure of sampling = 0.911 Barlett's Test of Sphericity is significant;  $p < 0.000$

**Table 2. Descriptive statistics for company characteristics and board attributes**

Variables	Mean	SD	Min	Max
Return on equity	2.61	28.47	-213.89	62.58
Board's risks oversight	3.97	0.42	2.80	5.00
Accessibility of information	3.68	0.48	2.32	5.00
CEO's performance evaluation	3.83	0.46	2.48	5.00
Performance of independent directors	3.81	0.43	2.58	4.80
Company size (RM)	1,880M	6,787M	25M	69,643M
Age of company (years)	15.28	11.64	2.00	48.00
Leverage (ratio)	41.61	20.63	4.63	89.64
Managerial ownership:				
At least 5%				
Frequency (%)	77 (44%)			
Less than 5%:				
Frequency (%)	98 (56%)			

Before running the regression analysis, the company size and leverage are transformed into

logarithm to prevent the heteroscedasticity problem. Besides, test for multicollinearity was carried out. Independent variables with variance inflation factor (VIF) values more than 10 show a serious multicollinearity (Chatterjee, Hadi & Price, 2000). The result shows that there is no evidence of multicollinearity since the VIF value is between the range of 1.157 and 1.469.

**Table 3. Regression results**

	<b>Coef.</b>	<b>t-value</b>
Board's risks oversight	0.175	2.103**
Accessibility of information	0.075	0.947
CEO's performance evaluation	0.031	0.364
Performance of independent director	0.139	1.716*
Managerial ownership	0.078	0.309
Company size	0.200	2.561**
Company age	-0.100	-1.323
Leverage	-0.144	-1.704*
R-square	0.187	
Adjusted R-square	0.148	
F statistic	4.788***	

\*\*\*, \*\*, \*indicates regression analysis is statistically significant at 1%, 5% and 10% respectively

The results of regression analysis are shown in Table 3. With regards to board process, board's

In addition, company performance is also related to performance of independent directors. Independent directors, who are able to provide strategic vision, prepare for board meetings and constructive challenge to the ideas of management team brings positive effect to company performance. The finding is consistent with Hasnah and Hasnah (2009) who assert that directors that are able to independently influence the decision making process are found in high performing companies. Besides, independent directors with sufficient knowledge on accounting and finance are able to have better understanding on company financial statement (Wan Fauziah, & Amrstrong, 2012).

The CEO's performance evaluation however, could not influence company performance. The possible reason is due to different procedures of CEO's evaluation between one company and another. The approach and procedures to evaluate the CEO is not standardized as 191 directors who responded to

risks oversight and performance of independent directors have significant influence on company performance. The results show no significant association between company performance and the independent variables of accessibility of information and CEO's performance evaluation. However, the expected direction of the relationship remains the same. Out of three control variables, only two variables namely company size and leverage indicate significant relationships with company performance. Company age indicates insignificant result.

## V DISCUSSIONS AND CONCLUSION

The study aims to examine the influences of board process and managerial ownership on company performance. The result indicates that board's risks oversight is associated with company performance. In that regard, board that raises concern on risks management, gets the senior management to use scenario analysis in identifying potential vulnerabilities, encourage the management to deliberate on emerging risks that the management anticipates the company will be facing and review strategy during crisis contribute to company performance.

The questionnaire informed that the evaluation process is conducted formally. Meanwhile, 72 directors answered the process is conducted informal. Besides, the company ownership also influences the evaluation process. Directors that have family ties with the controlling shareholders reduce the procedure in CEO's evaluation (Westphal, 1999). The result also indicates that the accessibility of information is not related to company performance. The possible reason is that the effectiveness of board in interpreting the meaning of the information is important rather than just accepting the information.

Besides, the result does not support that there is significant relationship between managerial ownership and company performance. One explanation for the lack of correlation between managerial ownership and company performance could be that this study does not differentiate between those who hold the shares for a long and short period of time. This may suggest that companies with owner-managers who hold the

shares for a long period are more established and well-known.

Besides, company size and leverage are other influential factors that influence company performance. Larger companies tend to have easy access of various resources which in turn, gives positive effect to company performance (Kula, 2005). Meanwhile, company performance is negatively related to company leverage. The result indicates that companies with high dependency on debt financing are unable to invest in more risky and profitable projects; thus, such situation affects company performance (Chang, 2004).

There are few limitations related with the methodology of the study. Directors who answered the questionnaires may not give honest responses as they might think that there is a risk that their answers could be revealed to the shareholders, regulatory bodies or competitors. However, guarantees are given in the cover letter that the directors' answers will be kept confidential. With regards to future research, studies on the influence of board's risks oversight and performance of independent directors on company performance are still scanty. Therefore, studies could be done to verify the result. Besides, the analysis based on the company sector may also constitute for future research.

## REFERENCES

- Baysinger, B., & Butler, H. (1985). Corporate governance and board of directors: performance effects of changes in board composition. *Journal of Law, Economics and Organization*, 1(1), 101-124.
- Carey, D., Patsalos-Fox, M., & Useem, M. (2009, October 26). Leadership lessons for hard times. *TheEdge Malaysia*, MW6-MW7.
- Chang, A. L. (2004). The impact of corporate governance practices on firms' financial performance: evidence from Malaysian companies. *ASEAN Economic Bulletin*, 21(3), 308-318.
- Chatterjee, S., Hadi, A., & Price, B. (2000). *Regression analysis by example*. New York: Wiley.
- Dulewicz, V., & Herbert, P. (2004). Does the composition and practice of boards of directors bear any relationship to the performance of their companies? *Corporate Governance*, 12(3) 263-280.
- Epstein, M. J., & Roy, M. (2005). Evaluating and monitoring CEO performance: evidence from US compensation committee reports. *Corporate Governance*, 5(4), 75-87.
- Finance Committee on Corporate Governance (FCCG), (2000). *Malaysian code on corporate governance*. Perpustakaan Negara Malaysia Cataloguing-In Publication Data: Malaysia.
- Finkelstein, S., & Mooney, A. C. (2003). Not the usual suspects: how to use board process to make boards better. *Academy of Management Executive*, 17(2), 101-113.
- Gomez, M. (2010). The need for performance measurement. *Accountants Today*, 23(1), p. 28-30.
- Haniffa, R. M., & Hudaib, M. (2006). Corporate governance structure and performance of Malaysian listed companies. *Journal of Business Finance & Accounting*, 33(7) & (8), 1034-1062.
- Harris, M., & Raviv, A. (2008). A theory of board control and size. *Review of Financial Studies*, 21(4), 1797-1832.
- Hasnah, K., & Hasnah, H. (2009). Roles of board of directors: Evidence from Malaysian listed companies. *Corporate Board: Role, Duties & Composition*, 5(1), 22-36.
- Ingley, C., & Van der Walt, N. (2008). Risk management and board effectiveness. *International Studies of Management and Organization*, 38(3), 43-70.
- Jensen, M. C., & Meckling, W. H. (1976). Theory of the firm: managerial behavior, agency costs and ownership structure. *Journal of Financial Economics*, 3(4), 305-360.
- King, T. D., & Wen, M. (2011). Shareholder governance, bondholder governance and managerial-risk taking. *Journal of Banking and Finance*, 35(3), 512-531.
- Kula, V. (2005). The impact of the roles, structure and process of boards on firm performance: evidence endure from Turkey. *Corporate Governance: An International Review*, 13(2), 265-276.
- Kula, V., & Tatoglu, E. (2006). Board process attributes and company performance of family-owned business in Turkey. *Corporate Governance: The International Journal of Effective Board Performance*, 6(5), 624-634.
- Macus, M. (2008). Board capability. *International studies of management and organization*, 38(3), 98-116.
- Mazlina, M., & Ayoib, C. A. (2011). Agency theory and managerial ownership: evidence from Malaysia. *Managerial Auditing Journal*, 26(5), 419-436.
- Raber, R. W. (2003). The role of good corporate governance in overseeing risk. *Corporate Governance Advisor*, 11(2), 11-16.
- Robbins, S. P., & Judge, T. A. (2009). *Organizational Behavior (13th ed.)*. New Jersey: Prentice Hall.
- Sang-Woo, N., & Il, C., N. (2004). *Corporate governance in Asia: recent evidence from Indonesia, Republic of Korea, Malaysia and Thailand*. Asian Development Bank Institute.
- Sobel, P. J., & Reding, K. F. (2004). Aligning corporate governance with enterprise risk management. *Management Accounting Quarterly*, 5(2), 29-37.
- Taylor, M. S., Tracy, K. B., Renard, M. K., Harrison, J. K., & Carroll, S. J. (1995). Due process in performance appraisal: a quasi-experiment in procedural justice. *Administrative Science Quarterly*, 40(3), 495-523.
- Wan Fauziah, W. Y., & Amrstrong, A. (2012). What competencies should directors possess? Malaysia perspective. *International Journal of Business and Management*, 7(2), 142-149.
- Westphal, J. D. (1999). Collaboration in the boardroom: behavioral and performance consequences of CEO board social ties. *Academy of Management Journal*, 42(1), 7-24.
- Wyman, O. (2009). *Risk Governance: Post-crisis priorities*. MMC.
- Yeap, C. (2009, August 24). Need for effective independent directors. *TheEdge Malaysia*, 60.
- Zahra, S. A., & Pearce, J. A. (1989). Boards of directors and corporate financial performance: a review and integrative model. *Journal of Management*, 15(2), 291-334.