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The relationship between Independent Non Executive Directors' and Audit Committee on Firm Performance among Malaysian Listed Companies

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Abstract
Various literature have discussed about various influences of corporate governance elements in firm performance The general assessment is corporate governance act as an instrument to support management's to achieve its desired goals with the stakeholder value especially in increase financial performance.Despite the broad studies of corporate governance there is still a different argument in the view of the influence of corporate governance on financial performance. Therefore, the aim of this paper is to identify the influence of two corporate governance variables on firm performance. The corporate governance measurement was measured by the Independent non executive director and audit committee as independent variables and firm performance is measured by return on equity (ROE) and earnings per share (EPS) as dependent variables. This study is purely quantitative whereby data were collected from secondary source such as published in journals and Annual Reports of the companies. This study discovered that, there is a significant influence of corporate governance on firm performance. Therefore, the results show that good corporate governance practiceinfluence firm performance. Finally, it's hoped

that this study provides current corporate governance set-up in Malaysia that can be used to improve the development of corporate governance.

Key words: Audit committee, Corporate Governance, Firm Performance and Independent non-executive directors.

1. Introduction

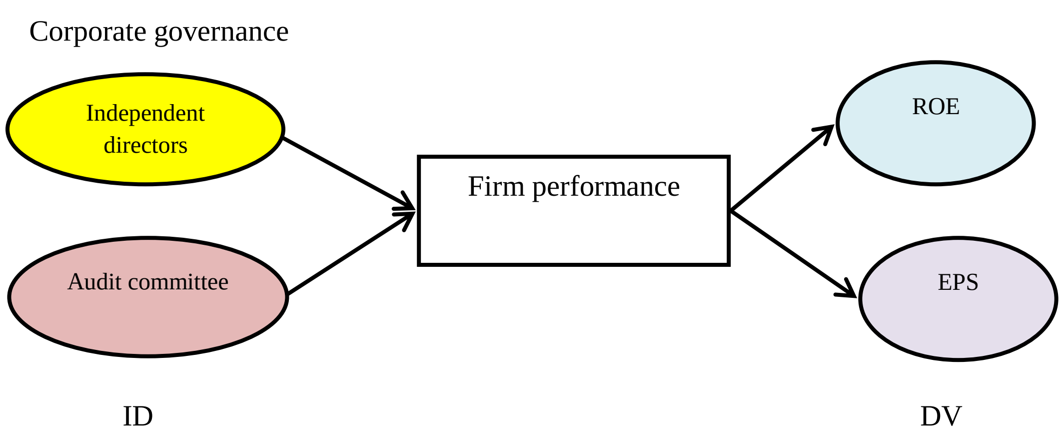
The Asian financial crisis in 1997 and the well-publicized corporate scandals such as Enron, Worldcom and Parmalat have highlighted the importance of good corporate governance practices for the long-term survival of companies. The accountability and transparency component of corporate governance would help companies gain shareholders' and investors' trust. The stakeholders need assurance that the company will be run both honestly and effectively. This is where corporate governance is critical (Morck&Steier, 2005), because it can improve stakeholders' confidence and sustainability of business in the long run.

Moreover, effective corporate governance reduces "control rights" shareholders and creditors bestow on managers, in increasing the probability of the firm, and managers are expected to invest in a positive project which will assure the investors safety of their investment (Shleifer&Vishny, 1997). In fact better-governed firms have better operating performance. Corporate governance (CG) is a way in which suppliers of finance to corporations assure themselves of getting a return on their investment. Irrespective of the particular definition, the importance of corporate governance arises in a firm because of the separation between those who control and those who own the residual claims (Epps &Cereola, 2008).

Many stock exchange and regulators around the world are increasingly looking to ensure high standards of corporate governance to attract more capital or foreign investment to the country. For example, following the Sarbanes-Oxley Act 2002, the New York Stock Exchange (NYSE) and National Association of Securities Dealers Automated Quotations (NASDAQ) proposed a new corporate governance listing-standard has been approved by the Securities and Exchange Commission SEC on November 4, 2003 (Kadan et al. 2009). The new listing standards include provisions regarding board composition and structure, audit committee composition and responsibilities and other corporate governance matters.

Theoretical frame work, review of Literature and development hypothesis

Fig-1. Research Model of the study



Specifically, this paper is aimed to identify the influence of two corporate governance elements to firm performance. To do so two main characteristics of corporate governance were selected include: independent non-executive and audit committee. This study is interested in measuring the performance of Malaysian companies on how corporate governance influence firm performance by the used of two financial ratios Return on Equity (ROE) and Earnings per Share (EPS). If good corporate governance is in place, it means there is a good board oversight of the management of the company. This would in turn ensure the company improves its performance. However, would that also mean that weak corporate governance leads to weak performance?

2. Independent variables (Corporate Governance)

For the purpose of this study two independent variables are:

2.1 Independent non-executive directors:

Independent non-executive directors are described as the "mainstay of good governance" (Editorial, 2003, p. 287), non-executive directors are also considered to be a guarantee of the integrity and accountability of company boards. An independent non-executive director is also defined as independent directors who have no affiliation with the firm except for their directorship (Clifford and Evans, 1997). There is an apparent presumption that boards with significant outside directors will make different and perhaps better decisions than boards dominated by insiders.

The Malaysian Code on Corporate Governance (2000) recommends, as a best practice, that there needs to be balance on the board of directors with at least one third of the board members should be independent directors. This is to ensure the effectiveness of the independent directors in maintaining the objectivity in board decisions. The argument for the need of independent non-executive directors on the board substantiated from the agency theory which states that due to the separation between ownership and control, managers (given the opportunity) would tend to pursue their own goals at the expense of the shareholders (Jensen and Meckling, 1976).Hence, by having independent non-executive directors on the board, these directors would help to monitor and control the opportunistic behaviour of management, and assist in evaluating the management more objectively.

H_0: Number of independent non-executive directors not influences firm performance.
H_a: Number of independent non-executive directors influence firm performance.

2.2 Audit Committee

Audit Committees ("Audit Committee") are recognized as the cornerstone of a successful and credible financial reporting system. DeZoort et al. (2002: 41) define an effective audit committee as follows: "An effective audit committee has qualified members with the authority and resources to protect stakeholder interests by ensuring reliable financial reporting, internal controls, and risk management through its diligent oversight efforts." However, numerous factors affecting the performance of audit committees need to be addressed in order to optimise their effectiveness and achieve their objectives. To improve the performance of audit committees and identify inefficiency and opportunities in order to enhance effectiveness, audit committees should adopt global best practices in meeting their financial oversight and governance responsibilities (Leblanc Diagnostics 2005: 6).

H_0: Number of audit committee not influence firm performance.
H_b: Number of audit committee influence firm performance.

3. Research Design and Methodology

3.1 Research design and sample

The main objective of this study is to investigate the influence of two corporate governance components and firm performance within the Malaysian corporate governance setting. Thus, this study uses quantitative methods. To do so, this study focuses on the Bursa Malaysia databases where data are obtained from annual reports of Malaysian PLCs, based on the FTSE Bursa Malaysia Index(as measured by market capitalization) between 2009 to 2011. 813 companies selected for analysis in this study were among the biggest companies in Malaysia; they are also recognisable in terms of their performance. The threeyear period chosen will also provide additional insight into firm performance which possibly affects the company's performance during the world economic crisis. The selection of sample used in this study is similar to other corporate governance studies (i.e.,Abdullah, 2004; Levrau & Van den Berghe, 2007; Van Ees et al., 2008).

4. Measurement procedures

4.1 Corporate governance

This study use two variables in place of corporate governance components, i.e. audit committee and composition of NEDs, in line with many corporate governance studies (Levrau & Van den Berghe, 2007; Van Ees et al., 2008; Awan, 2012). First, we calculated the number of audit committee in the data set. Second, we measured we classified each director as either an executive (inside) director or a nonexecutive (outside) director. This allowed us to calculate the percentage of outsiders on each board.

4.2 Firm performance

Although there are many measures of firm performance, this study followed the predominant approach and used two financial measures of firm performance, Return on Equity (ROE) and Earnings per share. Financial measures of firm financial performance fit into accounting-based measures. Examples used in the governance literature include ROA and ROE (Rahman & Haniffa, 2006, Haron et al., 2008; Awan, 2012), In general, the major concern with accounting measures is that they are historical and so lag the actual actions that bring about the results. As well as this is a common measure used in the literature.

5. Data Analysis

The annual reports of the companies that were downloaded from the Bursa Malaysia Website have been entered into a database. The files were then exported into a SPSS file for further analysis. This study employs descriptive and parametric statistical analysis. Since the hypotheses predict the non-directional of correlation, we employed two-tail significant tests. In order to test the hypotheses, Spearman's correlation matrix was employed. The Spearman's correlation was to identify the relationship between corporate governance and firm performance.

5.1 Results and discussions

5.1.1 Independent Non-Executive Directors has an influence on Firm Performance

The analysis of Spearman's correlation matrix is conducted to find the influenceindependent non-executive directors on firm performance reported to be mixed (Table 1). At significant level .05, the relationships were not significant for 2009, 2010 and 2011 for ROE with $r = .102, .097$ and $.102$ ($p = .093, .110$ and $.088 < 0.05$). However, at significant level .01, in 2009, 2010 and 2011 independent non-executive directors influenced the EPS with r = .221, .259 and .243 (p = .000, .000 and .000). This result confirms with previous study which revealed an inconsistence influence between independent directors and firm performance (Abor & Adjasi, 2007; Rahman and Mohamed Ali, 2006). The positive effect can be explained because the presence of outside independent directors on boards enhanced corporate competitiveness and provided new strategic outlooks for the firms (Abor & Adjasi, 2007). By emphasizing the potential for divergence of interests between investors and managers, agency theorists predict that where board of directors is more independent of management and enhance the auditing system of the companies (Salleh et al.,2005), and finally increased company performance would be higher.On the contrary to the fact that there is noinfluence of the two independent and dependent variables can be resulted on the arguments that have limited time to involve in company operation (Conger & Lawler, 2009). As a whole the result of the influence of independent non-executive directors on firm performance among Malaysian companies is mixed. Therefore, the hypothesis (Ha) is accepted.

Table (i) Hypothesis-1. Independent Non-Executive Directors and Firm Performance

Firm Performance variable	Corporate governance variable	2009		2010		2011	
		R	**Sig.**	**R**	**Sig.**	**R**	**Sig.**
Return on Equity	Independent Non-Exec. Dir.	.102	.093	.097	.110	.104	.088
Earnings per Share	Independent Non-Exec. Dir.	.221**	.000	.259**	.000	.243**	.000

*. Correlation is significant at the 0.05 level (2-tailed).
**. Correlation is significant at the 0.01 level (2-tailed).

5.1.2 Audit committee has influence on firm performance.

The results of Spearman's correlation matrix are conducted to find the influence of the audit committee and firm performance reported mixed results (Table 2). The relationships was not significant for 2009, 2010 and 2011 for ROE with r = .108, .055 and .117 (p = .075, .365 and .117 < 0.05). However, in 2009, 2010 and 2011 audit committee was significant for EPS with r = .210, .282 and .249 (p = .000, .000 and .000 < 0.01). However, ROE was not significant for audit committee in 2009, 2010 and 2011. Therefore, the null hypothesis (H_0) is rejected and it is concluded that effective audit committee result in higher performance, accepting the alternative hypothesis (H_b).

Indeed, the size of the audit committee could be an indication of the seriousness attached to issues of transparency by the organization and this sends the right signal to the public who then develops confidence in the organization. Again, Watts and Zimmerman (1986) indicates that there is the tendency for large firms to make accounting choices which reduces the probability of regulatory scrutiny and also cite other literature documenting the penchant for firms to make accounting choices aimed at smoothing out reported income. In this circumstance, the presence and to some extent the size of the audit committee is an assurance mechanism to promote fairness.

Also, it has been argued by Menon and Williams (1994) that for audit committees to be effective monitors, it is not enough just to be independent and that they must be active (measured by the frequency of their meetings). On the audit committee, this shows that the hypothesis is supported, contrary to the study of Anthony Kyereboah-Coleman. (2007) who relatively found that there is no positive influence in a number of audit committee to firm performance.

Table (ii) Hypothesis-2. Testing for Audit committee and Firm Performance

Firm Performance variable	**Corporate governance variable**	**2009**		**2010**		**2011**	
		R	**Sig.**	**R**	**Sig.**	**R**	**Sig.**
Return on Equity	Audit committee	.108	.075	.055	.365	.095	.117
Earnings per Share	Audit committee	.210**	.000	.282**	.000	.249**	.000

***. Correlation is significant at the 0.01 level (2-tailed).**
****. Correlation is significant at the 0.05 level (2-tailed).**

6. Conclusion

The purpose of this studyis to identify the influence of corporate governance on firm performance. Two hypotheses were developed and tested each variable to identify the influence of each of the corporate governance variables (Independent non-executive directors, and audit committee) in relation to two performance indicators (ROE and EPS). The significance of one of CG aspects, namely board characteristics. In general, the results show that investors consider good governance practices are more important in their investment decisions. This implies the significance of good corporate governance has an influence on firm performance. The findings are also backed for the hypotheses connecting board characteristic variables and firm performance. Good corporate governance was found to moderate many influence of theboard's characteristics to firm performance. It was discovered that no single theory offers a complete explanation of boards characteristics-firm performance relationship, but rather elements of each theory can be seen to apply in different circumstances. Therefore, the protection of minority shareholders' rights remains a key issue in Malaysia as controlling shareholders exercise dominant control via ownership concentration and representation on company board and management. However, we should consider the limitations of this study because the small sample size and a special industry may not render the results of the study to be generalized. In addition, the duration of study should be more than three years because the effect of independent variables will be during subsequent periods.

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