A Propitious Approach towards Independent Directors in Malaysian Firms’ Board Committee

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Abstract

Independent directors at board committee have never taken a center stage, until when the world economy faced a global financial crisis stretching from the late 1990s to the late 2000s. Corporate governance ultimately calls for more controls and checks to be exercised at the board and committee level. Monitoring by independent directors of the top level management, is now viewed with more propitiation, complementing existing auditing activities, nominating and evaluating compensation to executive directors. The propitious approach is being interpreted as accepting independent directors favorably by increasing their representation at the board room and committee, which may be translated towards profit generation. A panel white standard error from an estimated 30 percent of the total Malaysian firms for period of 10 years suggests that nomination and remuneration committee gear the company towards generating profit.

Keywords: propitious approach, independent directors, board committee, corporate governance and profit generation

1. Introduction
1.1 Background

A board room with independent directors’ audience has been exercised as early as mid 1980s in United States and Europe. In the Asian region or Malaysia in particular, prior to the Asian financial fallout it has not taking up the center stage of the management attention. Without doubt questions are raised, as to the amount of cost in obtaining and engaging the service of independent directors. Over the years, it is observed that there has been much development as to the appointment of independent directors both at board level and audit committee. Particularly in Malaysia, the firms are seen to have viewed independent directors more propitiously, with increased composition of independent directors at the board room and board committee. These directors sitting at the board-room and board committee are anticipated to bring about more independent and meaningful judgment to business decisions. Subsequently it may contribute to a more effective boards’ deliberation and decision making process (Tinggi et al., 2014). An effective board room and board committee may help to drive the organization to achieve better quality decision, a more open financial reporting and subsequently expected to improve audit process and output (Beasley et al., 2009; Turley & Zaman, 2007; Zaman et al., 2011). Independent or outside directors in the organization are not on full time basis. Their audience can only be felt when they come for board meeting or carrying out the monitoring activities of the board committee, and certainly are not privilege to a fixed compensation. The amount of time spent with the company is limited and access to information is certainly constrained. Consequently, it will be more difficult for independent directors to exercise diligent judgment. Being assigned as monitoring agent at the board room and committee level in order to oversee the activities of the senior management is indeed a daunting task to independent directors. Firms are more familiar with the commonly prescribed role of both internal and external auditors, who are engaged to ensure that internal control is taking place and that compliance in the preparation and reporting of financial statement is accomplished effectively. While firms are obliged to pay hefty normal auditing fees, those firms are now equally instituted to pay monitoring fees to independent directors who are expected to assume the responsibility of a monitoring agent, this time round, both at the top or strategic management level. Independent directors would perform the duty of their oversight role which is distinct from the role assigned to the senior management.
executives. In the exercise of the independent directors’ duty, they are expected not to display any form of biasness and partiality to any parties, when conducting monitoring activities or valuing managerial performance of the organization’s top executive. While there is no obligation to institutionalize statutory compliance, the corporate governance code of best practice recommends that independent directors are strongly encouraged to exercise independent judgment and impartiality in the decision-making process than members of the top management executives, comprising the Chief Executive Officer (CEO) and the other executive directors.

The 1997’s Asian financial crisis in countries such as Indonesia, Thailand, Philippines and South Korea has triggered the interest of the national governments and corporate leaders. Weakness of the national and firm financial structures was severely exposed and identified. Huge financial losses that were unseen before were reported. Foreign funds that were invested in the equity portfolio and commercial bank loans brought about negative returns. An original sum of US$12.1 and US$55.5 billion invested in the Asian regions resulted in a negative US$11.6 and US$21.3 billion respectively (Poon & Perry, 1999). The demise of a United State energy company, Enron, saw its corporation market value shrank from US$90 per share in 2000 to less than US$1.00 in October 2001, representing a significant drop of 99 percent. It was followed by a magnitude of job losses, directly and indirectly, of 6,500 and 28,000 respectively in Arthur Andersen’s US operation (Dugan & Spurgeon, 2002). Subsequent to this, also saw the downfall of WorldCom, which has resulted in massive job losses of 17,000 employees, with its market value shrinking from US$60 in 1999 to US$2.00 per share in March 2002 (Brickey, 2003). The latest straw of melting down was the 2007/2008 subprime mortgage crisis in the United States, exposing more disintegration in the country financial structure. A negative growth of 23.72 percent in the fourth quarter of 2007 in US banking industry was reported, with some US$3.0 trillion in private label structured assets was forced to be liquidated. Subsequently, it deprived the US economy a vast amount of liquidity assets (Whalen, 2008). Investors’ confidence in the financial market was severely undermined. In the aftermath of the financial crisis, more financial shocks will be anticipated to happen, if the weakness among financial structure is left unattended. Investors and financial analysts even contemplated that the diluted investors’ confidence and unstable financial structure may have aggravated the economic ripple effect in many different parts of the world, particularly such as the current financial instability experienced in Greece, Portugal and Ireland in 2011.

Malaysia was not free from the financial fallout. Confidence among investors and foreign currency managers grew increasingly low, with vast under-valuation in stock market capitalization. In early 1998, the value of ringgit to a dollar took a nose-dive and was reported to have reached its lowest point at 4.88 ringgit to a US dollar, compare to its pre-crisis value of 2.57 ringgit in July 1997. In the same period, the Bank Negara of Malaysia found that it has lost US$10 billion in its effort to shore up the value of Malaysian currency against the US dollar, thus exacerbating the pains already suffered by the Malaysian people. Indeed, two thirds of the value of the Malaysian stock market wealth were wiped out from its last six years of cumulative growth. With the new but a discouraging financial landscape, the governments around the world including Malaysia rushed to introduce new business legislation in a final effort to improve the level of corporate governance practice, and in effect will restore investors’ confidence. May be it was the first real attempts to reform a firm which may begin from the top, including the members of the highest decision committee, which is the board. The latter is typically accountable to the fiduciary responsibilities assigned to them in order to safeguard the interest of the shareholders, especially the minorities and ensuring that the well-being of the corporation is taken care of. The inside and executive directors sitting at the board has been critically queried, pertinent to their efficiency and effectiveness as custodian of the company’s assets. The inside directors who then, oversee the management activities at the upper level and the evaluation of the firm’s senior management and the chief executive officer (CEO) compensation perhaps might have been taken lightly. Early literature from Baysinger and Hoskisson (1990) and Kesner and Dalton (1986), highlighted that the inside directors which are shouldering the responsibility as former monitoring agent may fear the plausibility of harsh negative counter action from the CEO and other senior managements. Consequently it may impede the good cause, capacity and capability of the inside directors to provide an impartial and meaningful monitoring activities. Fleischer, Hazard and Klipper (1988) and Weisbach (1988), also give evidence that inside directors are being dragged into a conflicting position. Their role of evaluating the senior management performance will be questioned, with conflicting objectives, first as members of the decision makers, and second, as evaluator and monitoring figure, which sometimes will affect the role that the director assumes. Subsequently it may interfere with the need to provide an effective discharging of responsibility required from the inside directors. Given the delicate relationship among inside directors which may bring about conflicting objectives and results, justification for engaging outside or independent directors may become more relevant. Outside and independent directors are certainly expected to bring about increased objectivity and clarity to the board decisions making activities. In effect, these efforts would help to improve organisational survival, cultivate firm’s growth and prosperity, and simultaneously
guarding and championing the interest of the general stakeholders (Malaysian Institute of Corporate Governance-MICG, 2003). Having addressed some of the agency threats, independent directors have the opportunity to discern larger issues which is over and beyond the normal profit-making concern of the organisation. In comparison, executive directors may have failed to display indifference and objectivity in the decision making process. The CEO may possibly, from time to time, interferes with the decision, authority and direction asserted by the inside directors. A significant finding by Scarabotti (2009), agrees that the board is not effective in promoting check and balance, if the board is mainly made up of individuals who are maintaining close ties, either directly or indirectly, with the senior executive management. Being objective and independent among directors are important in those areas where there is likelihood that conflict of interest between managers and shareholders may arise. Given the above picture, the appointment of independent or outside directors is foreseen to have brought about more value added to the corporate board, in terms of impartiality, professionalism and effectiveness (Tinggi, 2014). While the appointment of independent directors is required, it is also seen to have increased agency cost, culminating in another monitoring cost that the firm has to bear with. Instead of ameliorating the agency costs, it has otherwise becoming exacerbated. Apart from financial obligations arising from the existing payment to external and internal auditors, firms would have to bear with the additional unavoidable new agency cost. While there is a potential benefit from deploying independent directors, it is also expedient to create the right balance between the number of independent directors engaged by the firm and the responsibility that is assigned to them. The rolling out of corporate governance among countries has made it almost obligatory for firms to fill the board room with independent directors. This has been the most important step culminating from corporate governance, in order to ensure that activities at the strategic level are monitored and overseen responsibly.

This research dwells on the ever green significant fundamental theory such as the agency theory, which will continue to highlight the useful relationship or a nexus of contract between relevant stakeholders, in this case is the investor and the management. A research by Jensen and Meckling (1976) finds that there is conflict of intention and interest between managers and shareholders. This so-called conflict driving the objective of both mentioned parties is expected to be caused by a diversity of interest and asymmetric information unintentionally borne by shareholders who have little or no access to the whole knowledge about the organization. On the other hand, corporate managers might have the personal privilege and motivation to steer the firm for their own self-interest. The managers who are moved by different interests would tend to behave and use the firms’ resources based on their own best interest, which may not be in line with the shareholders objective, whose main aim is to maximize return from the shareholders’ fund. While firms continue to use the service of internal and external auditors, the result has not been overwhelmingly positive, as firms are still exposed to weak financial structure. A more effective monitoring substance is required, and in the light of this argument, independent directors are strongly recommended. Without doubt the author looks upon the contribution of the Resource dependence theory (Daily, Dalton, & Camella, 2003; Hillman et al., 2009) which would call upon the board members’ contribution as boundary spanners of the organization and environment. It is potentially built on the resourceful supply of independent directors, who have acquired wealth of business experience and skills and to take advantage of their collaborative edge that could be assimilated into the organization for good effect. The independent directors are meant to provide access and bridging to different but relevant resources and synergies needed by the firm. The independent directors who are specially selected would mainly come from group of qualified individuals and professionals. Some are assumed to have acquired many years of auditing experiences, bringing along with them qualities of greater credibility and attestation (Robertson & Davis, 1985), and hopefully will improve quality of reporting and minimize potential risk (Messier et al., 2007). On top of that, is the motivational factor, derived from the normative auditing theory, (Robertson and Davis, 1985), which provides guidelines on the characteristic of the monitoring or auditing agents allowing for the possibility of achieving a normative result, thus giving an indication of what a good practice would have been liked. In this respect, the auditing theory will provide guideline as to the standards of the professional skill, and the level of independence, that will require directors to be objective and professional in the discharging of their duty.

1.2 Problem Statement

In an attempt to introduce independent directors at the board room and at the board committee, the representation of independent directors has not been uniformly specified. Indeed companies at the early stage may have viewed the engagement of independent directors with little or no favor at all, contemplating that it may have brought about extra costs instead of financial benefits. A favorable or propitious view towards independent directors is certainly missing. This may have caused to find no standard number of outside or independent directors employed by companies in many parts of the world. The composition of independent directors that is adopted by
one country for each firm is not similar to another one adopted in another country. At the early stage of prompting independent directors in the organization of each country, and for the purpose of implementing the code of corporate governance, multitude of heterogeneity in the number of independent directors is traced. There is no common yardstick as to the number of independent directors who would serve as monitoring and auditing agents at the board room and well as at the committee level. Each country will set the limit on the number of independent directors which may sit at the board for each firm. While a minimum of one third of independent directors of the total board composition is established, others will require at least fifty percent which are made up of independent directors. There are also some which also accept a smaller representation of its independent directors at the board room. In the United States and Australia, a minimum requirement of 50 percent of independent or outside directors is established in the board room, thus making it possible to take advantage of its simple majority position to exercise the mandate vested in them. Other parts of the world, like India for instance, a 50 percent minimum requirement is used when the chairman is an executive; while in South Korea and United Kingdom, a composition of 50 percent is effectively used for big firms or conglomerate of firms. However, a more radical approach from countries like Germany and Japan is found, where the role of board of directors in corporate governance practice takes a different platform. Japan allows for a minimum of one independent director provided that the firm is adopting a US-based three committee structure, with at least two outside directors are required. In West Germany, it encourages a dual board structure, to ensure that a check and balance at the strategic level is effectively exercised.

Globally, three approaches are widely used in the application of corporate governance practices. First, the prescriptive method, which allows companies to follow corporate governance code strictly, second, the non-prescriptive method, that will require companies to be more flexible in disclosing their actual practices and, finally, the hybrid method, permitting companies to vary the exercising of the corporate governance code according to the current circumstances under which the firm operates. Against the background of this corporate governance framework, Malaysian authorities without doubt have implemented the hybrid method. Public Limited Company (PLC) in Malaysia is encouraged to apply on a voluntary basis the principles of the Code of Corporate Governance and to explain any variation that may have deviated from the Code of Corporate Governance best practices. In this way, the hybrid method which adopts a representation-based approach paves the way for independent directors to play a more proactive role over the management of the organization. Certainly, the listing requirement in Malaysia has made it near to mandatory, that the independent directors should be well represented at board level among all listed firms in Malaysia. While some firms in Malaysia are obliged to set at either one third or minimum of two numbers, whichever is lower, others are more willing to increase the representation of the independent directors at the board room. The audit, nomination and remuneration committees are also established making up mainly of independent directors. The listing requirement certainly encourages that the audit committee which comprises an estimate of three directors, proposes that the majority of the composition would come from independent directors. The committee at both the remuneration and nomination level is expected to be mainly composed of the independent directors. Indeed, the stimulating factor to carry out this research is certainly an attempt towards evaluating and reviewing the influence of independent directors’ adoption among firms in Malaysia from 2001 to 2009 both at board room and at committee level. It is certainly a test of rewarding a progressively propitious acceptance of independent directors. During this period of investigation, it will be observed that there is serious beginning on the establishment of code of corporate governance, which will highlight the significant role of independent directors. Focus is made on the role of independent directors in all the three committees. It is not surprising that that there is propitious adoption of independent directors over the years. The firm will not stop at just the deployment of independent directors. Certainly independent directors would be expected to contribute further, such as to orientate the company towards profit generation. Independent directors are anticipated to originate from pool of talented individuals and professionals, accountants and auditors. Together they will bring along with them wealth of experiences in both public and private practices. The skill and craft to spot both the strength and weakness are required from them, thus, in effect will gear the companies towards better performance through profit orientation and generation. This research is indeed providing great motivation to investigate more on the role of independent directors, which may culminate in increased value on firms’ performance from their expertise, professionalism and experiences. The research feels that the role of independent directors would still not be effective if their presence cannot be felt and enforced at the board room. The companies should built trust and confidence on the abilities of independent directors. The firms are encouraged to accept, favor and propitiate deployment of independent directors and translate their engagement by increasing their representation both at the board room and at the committee level. In effect it is hoped that their contribution to the organization can be more effective.
In the light of the above issues, the primary objective of the study is to determine if the engagement of independent directors at the board committee is being viewed upon with more favor and propitiation by Malaysian firms. The broad objective would path the way to find more micro contributions from the independent directors’ role. The research is further conducted with some specific objectives, which are identified as follows:

(i) To assess if propitious acceptance of independent directors tasking as nomination, remuneration and audit committee bring about profit generation; and,

(ii) To evaluate if increased representation of independent directors at the board and committee level is favored that would orientate the company towards profit generation.

2. Literature Review

Independent or outside directors’ engagement in the areas of corporate governance has claimed increased attention among researchers and academic peers. It has somehow stimulated many interested parties to conduct a more in depth study of similar research, most saliently on the role and contribution of the independent directors to firms.

The listing requirement in Kuala Lumpur Stock Exchange (KLSE) has stipulated in Part A, 1.01, that a person is regarded as being qualified to become an independent director, when the candidate is not bound by any business or any form of relationship which may affect or interfere with the execution of the person’s independent judgment. An ability to act in the best interest of the independent directors may be affected, if the status of that “independence” is being disputed. This widely accepted role of independent director is specifically and commonly defined as: In the United States, the National Association of Corporate Directors Blue Ribbon Commission, 1996 sees that independent directors have no relationship to the corporation; In France, the Vienot Report II, 1994 regards independent directors as free of corporation’s management so that it will not jeopardize the person judgment; In United Kingdom, the Combined Code 1998 portrays independent directors as independent in character and judgment; In Canada, the Dey Report, 1994 defines independence as a free from any interest and any business or other relationship and in Australia, the Bosch Report, 1995 only assures independence when the director is not a substantial shareholder of the company and holds no executive capacity (Malaysian Institute of Corporate Governance-MICG, 2003).

Studies in the past have presented mixed findings. Independent directors are seen to have contributed to organization either directly or indirectly, filling in the gap precipitated from agency problem, as a result of conflict of interest between managers and shareholders and the principal-principal agency theory, culminating from rivalry of motivation between the dominant and the minority shareholders. The independent directors who are called upon to assume monitoring responsibility show that their action in the pasts reported mixed repercussion on firms’ performance. Studies in the Unites States by Bhagat and Black, 2002 find that there is lack of correlation between board independent and corporate capitalization. Hermalin and Weisbach (2003), De Andres, Azofra, and Lopez (2005), Jackling and Johl (2009), and Giovannini (2010) report inconsistent evidence of the influence of independent or outside directors on firm value. However, research conducted by Choi, Park, and Yoo (2007) on Korean firms and Dahya and McConnell (2007) on UK firms, portray encouraging results, that independent directors involvement bring about improved market capitalization. Outside Directors can improve board effectiveness and firm performance (Weisbach, 1988; McKnight & Mira, 2003; Anderson & Reeb, 2004). In an empirical cross sectional study of 12 Chinese banks from 2003-2006, it is found that outside directors has brought about encouraging impact on bank performance (Bai & Nam, 2009). It is indeed cannot be denied that contribution from independent directors shows mixed results. The evidence is traced back to past research from different countries in many parts of the world as to the deployment of independent directors at the board room. Some companies like India and United Kingdom, recognize the value of increasing dominance of independent directors, and some countries may progressively raise the representation of independent directors at board room and committee, a sign of accepting independent directors propitiously. Others may still adopt a passive approach, and without resorting to any significant change in the representation of independent directors at the firm’s board room.

2.1 Board of Directors

Board of directors is sometimes called the board members. It is regarded as the highest decision making body and decision of the board that is adjudicated and passed will be the final decision. Members of the board would normally comprise the executive or non-executive chairman, the chief executive director and the rest of the directors. The board may be further sub-divided into the executive directors, who are appointed on full time basis
and the other are the non-executive independent directors, whose audience can only be felt when they come for board meeting. The listing requirement in Malaysia requires that at least two or one third of the total board members should make up of independent directors, and at least one of them, will be regarded as competent and qualified. The listing requirement may also require the disclosure of the senior independent director/directors and the exact role of the chief executive officer (CEO) and the chairman, as the executive chairman may simultaneously hold the post of a CEO. Independent directors will be required to serve in all the committee namely, the audit, nomination and remuneration committee, or in any of the above committee, as stipulated in paragraph 15.10 of the Kuala Lumpur Listing Requirement (MICG, 2003).

2.2 Audit Committee

The Malaysian code of corporate governance clearly stipulates that the audit committees should be consisting of a minimum of three directors, recommending that the independent should form the main bulk of the composition. The objective of the audit committee is to cultivate a strong business culture which will highlight the need to uphold a sound system of internal control in order to protect shareholders’ investment and the company’s assets. An audit committee is expected to be effective in strengthening the position of internal and external auditors in pursuance to the continuous upgrading of the standards of financial reporting and auditing. With sound internal control and transparent reporting, company will be able to manage its firms’ financial structure properly in order to strengthen its financial position. Consistent with this drive, findings from Ravina and Sapienza (2010) and Cook, Barbara, and Wang (2011) report that independent directors who are members of audit committee helps to improve firm’s performance. To ensure that the process of auditing is exercised responsibly by the audit committee, the latter is expected to be impartial and objective, while discharging its duty competently. Given this, the listing requirement strongly calls for majority of the audit committee to have possessed accounting or finance qualification. It is highly recommended that at least one must be a member of the Malaysian Institute of Accountants or has 3 years’ working experience and is a member of any professional accounting association or body.

2.3 Nomination Committee

The nomination committee is provided under the Malaysian code of corporate governance, stipulated in Part 2 AA VIII. It is strongly recommended that the nomination committee should be made up wholly of independent directors. Even though there is a provision under section 128 of the Companies Act 1965, which governs the appointment and dismissal of directors of a public company by ordinary resolution, appointment of independent directors in the nomination committee to reinforce the function is certainly significant. The function of nomination committee is to nominate and re-nominate directors based on their contribution and performance and also to gauge the integrity of the status of independence of the company’s independent directors. Any effort to allow the CEO to sit in the nomination committee should be discouraged so that the CEO will not be able to interfere with any of the independent directors’ activities. Fich and White (2005) opine that the CEO who is a member the nomination committee has the likelihood of protecting his or her private interest. Consequently it will hamper the objective of advancing the interest of the company’s shareholders.

2.4 Remuneration Committee

Independent directors in remuneration committee serve to determine the level of compensation or remuneration that is due to executive directors of the company. The remuneration will normally be gauged by linking rewards to performance of executive directors. The Malaysian code of corporate governance recommends that the remuneration committee should be wholly or mainly comprise non-executive directors. Independent directors sitting in the committee should be free from any interference or any prejudicial influence surfacing from the senior management or shareholder. From a study by Cook et al., 2011, independent directors sitting in the audit and compensation committee enhance trading performance on sales.

Highlighting the significance of the underlying theory contributed by the Agency Theory, the Normative Auditing Theory and the Resource Dependent Theory, the conceptual framework is developed to investigate further the positive role the independent directors could render, both at the board room and committee, to promote check and control or growth and subsequently gearing companies towards profit generation.
2.5 Development of Research Hypothesis

Independent directors are appointed for the purpose of monitoring strategic activities and to provide check and balance at the board room and board committee level. In this way the organization could cultivate an improved system of internal control. It has been argued that to be effective the effort of independent directors should be clearly felt. With increase representation and being accepted favorably, independent directors will be expected to be more effective to carry their weight to move the company towards profit generation.

Thus, the first hypothesis is developed;

**H1:** There is strong relationship between Independent directors who are propitiously accepted at the board room and committee level towards profit generation.

The independent directors would be required to serve at the audit, remuneration and nomination committee. The code of corporate governance 2001 (revised 2007 and 2012) recommend that the audit committee should consist of three directors of which two of them will make up of independent directors, whilst it is strongly recommended that the remuneration and nomination committee should be mainly composed of the independent directors. In a nutshell, the firm is encouraged to view the role and responsibility of the independent directors more favorable and propitiously at both board room and committee level, if the firm eventual purpose is to generate profits.

In the light of the above, three more hypotheses are developed.

**H2:** Independent directors who are members of the nomination committee are viewed preferably to move the firms toward profit generation.

**H3:** Independent directors in the remuneration committee are favorably associated to steer the firms towards profit generation.

**H4:** Independent directors who are also members of the audit committee would drive the firm towards profit generation.

3. Research Methodology

A panel data from 381 Malaysian listed companies was used. It is consisting of an estimated thirty percent of the total companies listed in Kuala Lumpur Stock Exchange, involving different types of industries of the main board from period 2001 to 2009. Data were extracted from as early as 2000, but the samples were subsequently finalized by deleting companies that have merged or being acquired; some companies failed to meet continuous listing requirement or suspended, while some firms suffered from wide fluctuation of the profit and loss value.

The research has been critically written to find the effect of propitious acceptance of independent directors. In this case, the propitious acceptance will be interpreted as the increase in favor to accommodate independent directors by giving them a more prominent role and an increased representation in board room and board committee. Statistically, when the data is collected from 2001 to 2009, there has been a strong evidence of increase representation of these independent directors.

The linear panel equation, with $lroa_{it}$ is formulated as a function of $\alpha + \beta_1 indbdit + \beta_2 audbdit + \beta_3 nobbdit + \beta_4 rembdit + \epsilon_{it}$, Where, $lroa_{it}$ is return on assets for generation of profit. The $lroa$ is measured by natural log of profit after tax of the firm’s total assets. $Indbdit$, which stands for independent director is a percentage of the independent directors in the board room. $Audbdit$, which is a percentage of independent directors in the audit
board form the basis for audit committee. The same principle applies to nomination and remuneration committee which is measured by percentage of independent directors in the respective nomination and remuneration committee. Thus, \( \beta_3 \text{nobdit} \) stands for nomination committee, \( \text{rmb dit} \), is for remuneration committee and, finally, \( \varepsilon_u \) is the stochastic error term.

The three advanced panel method of analysis used to analyze the data are: First, the constant Co-efficient model or the Ordinary Least Square (Pooled OLS) Model, where \( lroa it \) is a function of \( \alpha + \beta_1 \text{indbdit} + \beta_2 \text{aubdit} + \beta_3 \text{nobdit} + \beta_4 \text{rmb dit} + Uit \).

Second, the Random Effect (RE) Model, where \( lroa it \) is a function of \( \alpha + \beta_1 \text{indbdit} + \beta_2 \text{aubdit} + \beta_3 \text{nobdit} + \beta_4 \text{rmb dit} + \lambda i + Uit \), when \( eit \) is decomposed into \( \lambda i \) (firm specific effect that has been excluded from the model and \( Uit \) (the remaining unexplained disturbance); and finally, is the Fixed Effect (FE) Model, where \( lroa it \) is a function of \( (\alpha + \lambda i) + \beta_1 \text{indbdit} + \beta_2 \text{aubdit} + \beta_3 \text{nobdit} + \beta_4 \text{rmb dit} + Uit \).

\[
(LM \text{ Test}, \quad LM = \frac{NT}{2(T-1)} \left[ \sum_{i=1}^{N} \sum_{t=1}^{T} E_{it}^2 \right] \left( -1 \right)^2 \]

The final model from the three options was carried out by first, the Breusch and Pagan Lagrangian Multiplier Which has helped to discriminate between a random effect and a Pooled OLS regression. The null hypothesis in the LM test is that variance of the error term is zero, \( H_0: \sigma_i^2 = 0 \) where the alternative hypothesis is \( H_1: \sigma_i^2 \neq 0 \). The LM is distributed as chi-squared with one degree of freedom under the null hypothesis. A higher chi² than the critical value or p value < the critical value at 95 percent confidence level, would mean, failing to accept the \( H_0 \), indicating that the variance of the error term is not constant. In effect the Constant Co-efficient model is not efficient, thereby the RE model is preferred over the OLS pooled model.

Another test is the Hausman test, \( Haus = (\hat{\beta}_{fe} - \hat{\beta}_{re})' \left[ V_{fe} - V_{re} \right]^{-1} (\hat{\beta}_{fe} - \hat{\beta}_{re}) \) is to distinguish the model choice between RE or FE. Denoting the variance-covariance matrix of \( \beta_{fe} \) and \( \beta_{re} \) by \( V_{fe} \) and \( V_{re} \), respectively, and letting \( k \), as the degree of freedom to be the dimension of \( \beta \), the Hausman statistic was formulated as above. The test is to determine if the country specific effects are correlated or uncorrelated with the regressors. The null hypothesis is \( H_0: \text{Cov}(\lambda_i, x_{iti}) = 0 \), where the alternative \( H_1: \text{Cov}(\lambda_i, x_{iti}) \neq 0 \). If the country-specific effects are uncorrelated with the regressors, the random effect estimator will deliver a consistent estimator that is efficient, in contrast to the fixed model which is unbiased under both the null and alternative scenarios.

Despite the robustness of panel data to common diagnostic problem, the threats of cross sectional and time series effect from the presence of multicollinearity, heterocedasticity and serial correlation would be tested. The data is looking for non-multicollinearity, \( \text{Cov}(x_1, x_2) = 0 \), presence of homocedasticity, \( \text{Var}(\varepsilon i) = \sigma^2 \) and is serially independent, \( \text{Cor}(\varepsilon i, \varepsilon j) = 0 \), to ensure validity of data set. Both time and firm specific effect variance are also tested. A final model of white standard error is used after eliminating the insignificant value of the firm effect dummy variables. The while standard error employs variance-covariance matrix (VCE) instrument which specifies the standard error which is robust to some kinds of misspecification, that allows for intra group correlation.
4. Findings and Discussion

Table 1. The summary of the regressors and dependent variable from panel data

<table>
<thead>
<tr>
<th>Regressor</th>
<th>Pooled OLS</th>
<th>Random Effect</th>
<th>Fixed Effect</th>
<th>Standard error robust cluster (code)</th>
<th>Time &amp; Fixed effect white standard error</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>1.830</td>
<td>1.4232</td>
<td>1.3845</td>
<td>1.8130</td>
<td>1.8658</td>
</tr>
<tr>
<td></td>
<td>(17.28)***</td>
<td>(14.01)***</td>
<td>(14.11)***</td>
<td>(0.1597)***</td>
<td>(0.1122)***</td>
</tr>
<tr>
<td>Indbd</td>
<td>0.7124</td>
<td>0.1959</td>
<td>0.5505</td>
<td>0.7123</td>
<td>0.7236</td>
</tr>
<tr>
<td></td>
<td>(3.76)***</td>
<td>(0.95)</td>
<td>(2.41)***</td>
<td>(0.3161)**</td>
<td>(0.1943)***</td>
</tr>
<tr>
<td>Aabd</td>
<td>0.2633</td>
<td>0.0131</td>
<td>0.0815</td>
<td>0.2633</td>
<td>0.1509</td>
</tr>
<tr>
<td></td>
<td>(1.79)*</td>
<td>(0.10)</td>
<td>(0.60)</td>
<td>(0.2357)</td>
<td>(0.1540)</td>
</tr>
<tr>
<td>Nobd</td>
<td>0.1641</td>
<td>0.0422</td>
<td>0.0067</td>
<td>0.1641</td>
<td>0.1675</td>
</tr>
<tr>
<td></td>
<td>(1.85)*</td>
<td>(0.39)</td>
<td>(0.05)</td>
<td>(0.1422)</td>
<td>(0.0841)**</td>
</tr>
<tr>
<td>Rmbd</td>
<td>0.5244</td>
<td>0.1682</td>
<td>0.0179</td>
<td>0.5244</td>
<td>0.5342</td>
</tr>
<tr>
<td></td>
<td>(5.27)***</td>
<td>(1.39)</td>
<td>(0.13)</td>
<td>(0.1718)**</td>
<td>(0.0973)***</td>
</tr>
</tbody>
</table>

Breusch and Pagan Lagrangian Multiplier (LM) 2305 (0.0000)***
Hausman 29.47 (0.0000)***

<table>
<thead>
<tr>
<th>tdum7</th>
<th>0.1476</th>
<th>(0.0608)**</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tdum8</td>
<td>0.1998</td>
<td>(0.0609)***</td>
</tr>
</tbody>
</table>

Heterocedasticity 5032 (0.0000)***
Serial Correlation 56.28 (0.0000)***

<table>
<thead>
<tr>
<th>Time variance</th>
<th>8.86</th>
<th>(0.0000)***</th>
</tr>
</thead>
<tbody>
<tr>
<td>Firm specific variance</td>
<td>5.82</td>
<td>(0.0000)***</td>
</tr>
</tbody>
</table>

Multicollinearity-vif 1.86

Observation 2759 2759 2759 2757 2757

Notes: Figures in the parentheses are t-statistics, except for Breusch-Pagan LM test, Hausman test, Heterocedasticity and Serial Correlation and Robust Cluster code and White Standard Error, which are standard error values. ** and *** indicate the respective 5% and 1% significance levels.

The process of selecting the appropriate model, the three panel instrument, Constant Co-efficient model, the RE model and the FE model was carried out. Discriminating between the Pooled OLS and RE models, Breusch and Pagan LM test in Table 1 reported a high chi square value of 2305 or p = 0.000 < 0.05. It has significantly failed to accept the null hypothesis that $H_0: \sigma_i^2 = 0$ suggesting that, the variance of error terms is not constant, thus rejecting Pooled OLS model. A Hausman test in Table 1 (chi square of 29.47 or p=0.0000 < 0.05) has also failed to accept the null hypothesis that $H_0: \text{Cov}(\hat{\beta}_i, x_{it}) = 0$, suggesting serial correlation problem does exist between firm specific effect and the regressor, thus rejecting the RE model. In summary, both Pooled OLS and RE models are both found to be inefficient and inappropriate.

Selecting the FE model is not the answer to the final instrument to be adopted, as it has problem of heterocedasticity ($F = 5032, p = 0.0000 < 0.1$) and serial correlation ($F = 56.28, p = 0.0000 < 0.01$). Further tests revealed that there is a presence of both the firm’s time and specific effect. The Standard Error Robust Cluster (code) does address the serial correlation and heterocedasticity but not the Fixed Effect due to time and firm variant. With the variance inflation factor (vif) value of 1.86, which is much below the critical value of 5.0, multicollinearity does not pose any threat. Given the dummy variable instrument for time effect, and eliminating the rest of the insignificant time effect dummy variables, and allowing for the retention of dummy lagged year 7 (tdum7) and year 8 (tdum8), a final model of white standard error is used. The model is regarded to be more...
robust to some kinds of misspecification while permitting for intra group correlation.

Regressing, all the exogenous variables against the endogenous variable find that a propitious acceptance of independent directors is associated strongly with the company’s ability to generate profit. The white standard error gives a strong t-statistic of 3.72 or \( p = 0.000 < 0.01 \), with standard error value of 0.1943, concurring with H1, that independent directors who are propitiously accepted at the board room and committee would significantly steer the company towards profit generation. Consistent with the pragmatic approach taken at the board room where the highest decision making is made pertinent to company’s policy and strategy, it will involve greater participation of independent directors. Likewise there is also a significant impact on profit generation when independent directors’ involvement is favored at the nomination committee. This is found to be significant with t-statistic at 1.99 or \( p = 0.046 < 0.05 \), at standard error equals 0.0841, supporting H2 that, independent directors who are members of the nomination committee are viewed preferably to move the firms toward profit generation. The Malaysian code of corporate governance, as stated clearly in Part 2 AA VIII, strongly recommends the nomination committee should be made up wholly of independent directors. This is to complement section 128 of the Companies Act 1965, which will specifically govern the appointment and dismissal of directors of a public owned company by simple or ordinary resolution. Getting the serious involvement of independent directors in nominating, appointing and reappointing directors would ensure that the appointment is not taken lightly. Directors know that their performance will be monitored and evaluated. Independent directors may also use their wealth of experience to nominate directors who have the potential to possess good business acumen that would translate directors’ responsibility into revenue and profit generation.

Regressing remuneration committee against profit, finds significant t-statistic of 5.49 or \( p = 0.000 < 0.01 \), with standard error equals 0.0973 for remuneration committee, thus extending leverage to H3 that independent directors in the remuneration committee are favorably associated, to steer the firms towards profit generation. Independent directors’ role in remuneration committee is to evaluate the level of compensations or rewards that is accrued to executive directors of the company. Theoretically and practically rewards to executive directors would be directly linked to their level of performance. In this respect, independent directors will provide an impartial and objective decision as to the rewards accrued to executive directors. The latter, knowing that their compensation will be evaluated on the basis of their performance will certainly not sit on its laurel but continue to find constructive and positive ways to generate company’s revenue and profit. Indeed this is consistent with the findings in research by Cook et al. 2011, where independent directors sitting in the compensation committee enhance trading performance on sales.

Finally regressing independent directors as audit committee find no significant impact on profit with t-statistic at 0.98 or \( p = 0.327 > 0.05 \), 0.1 confidence level, with standard error equals 0.1540. It thus fails to accept H4 that independent directors who are also members of the audit committee would drive the firm towards profit generation. As an audit committee, the independent directors will perform the monitoring activities to ensure that compliance in policy implementation is carried out at the upper level. Like the internal and external auditors, there is no evidence of revenue generation that can be contributed by the audit committee. This is perhaps due to the fact that the company may require the audit committee to focus its responsibility more on meeting compliance rather than anything else.

5. Conclusion

Highlighting the needs to appoint independent directors in preserving good corporate governance has been the leading issue for discussion among researchers, academic peers and policy makers. Striking a balance between policy compliance and firms’ performance has been hotly pursued. While the company takes serious view of policy compliance and transparent reporting, organization performance is equally important. Independent directors undertake complementary auditing role in the audit committee with the primary purpose to pursue compliance in reporting and policy’s implementation. There is no evidence that it will lead to firm’s performance. Independent directors who serve in the nomination committee will be given the opportunity to recommend to the board the candidate who may possess the business and entrepreneurial acumen to be the directors of the company, and translate the potential to generate income. On another note, directors whose performance is evaluated by independent directors at the remuneration committee would respond to a call that they no longer be given a free ride. The time has come that will push them to achieve company’s performance through income generation. This research is conducted with the company’s overview towards independent directors over the years, and there is some striking evidence that independent directors are being accepted more favorably. By being accepted more propitiously both at the committee and at the board, independent directors’ engagement in the company has contributed to firms’ income generation.
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References


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