

Characteristics of Boards of Directors and Board Effectiveness: A Study of Malaysian Public Listed Companies

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ABSTRACT

Boards of directors are integral to modern corporations and, consequently, receive much attention from regulators, researchers and stakeholders. Although this domain is receiving increased scrutiny, most studies have been based on relating various dimensions of board structure and composition to firm financial performance. However, such studies have failed to draw an unambiguous conclusion about the impact of board structure and composition on firm performance. Considering the importance of board dynamics on the effectiveness of the board, this study examines the characteristics of members of boards of directors and determines the contribution that these characteristics make to the effectiveness of boards of directors in Malaysian Public Listed Companies (PLCs). Furthermore, there is limited study in this area from emerging-economy countries with relatively less developed capital markets. The underlying theme throughout this study is that characteristics of members of boards of directors are important components of board effectiveness.

Based on extensive literature, this study develops a theoretical framework and six research questions. The characteristics of boards of director members considered in this study include demographic characteristics, personality characteristics and values, and competencies. Concerning the characteristics of effective boards, this study used a range of boards of directors' attributes including board roles, structure, composition, board membership and board dynamics. However, as this study utilised a qualitative approach, board effectiveness was assessed by reference to the participants' points of view of their overall boards. In other words, what is being assessed in this study is not the relationship between board characteristics and firm financial performance but rather the participants perception of their boards.

Data in this study relied on two key sources: in-depth interviews and publicly available data from 2007 annual reports of the top 100 Malaysia PLCs. In-depth interviews were conducted with 33 directors of the top 100 Malaysian PLCs and 8 representatives of Malaysian corporate governance organisations. They were chosen because of their knowledge and experience in Malaysian corporate governance.

The results of this study show that board members' demographic characteristics (age, tenure, multiple directorships), their personality characteristics and values (commitment, integrity, open mindedness, relationships with others) and their competencies (experience in corporate management, relevant knowledge and skills and relevant types of educational qualifications), as well as good networking with the government, are integral components of the effectiveness of Malaysian PLC boards. In addition, four

components that have been found to be important for the effectiveness of Malaysian PLC boards include competence and diverse backgrounds of board members, a good culture, clear roles and responsibilities, and well-defined board structures. More importantly, the results indicate that board membership is the most important component influencing board effectiveness for Malaysian PLCs. Although the relationship between board characteristics and firm performance has not been addressed directly, this study contributes to the understanding of the important characteristics of board members and board effectiveness.

This thesis makes a number of contributions. The results add to the knowledge base for countries with developing economies. Further, it contributes to theory by proposing an integrated model of board effectiveness, which provides a basis for future hypothesis testing and theory building to identify more consistent relationships between the characteristics of boards of director members and firm performance. Testing the framework against firms' financial performance provides an avenue for future research that can contribute to closing the gap in the knowledge that exists concerning the relationship between board members' characteristics and firms' financial performance.

In conclusion, the results from this thesis may have some implications for Malaysian regulators and others concerned with the establishment of guidelines pertaining to the selection of effective board members and effective boards.



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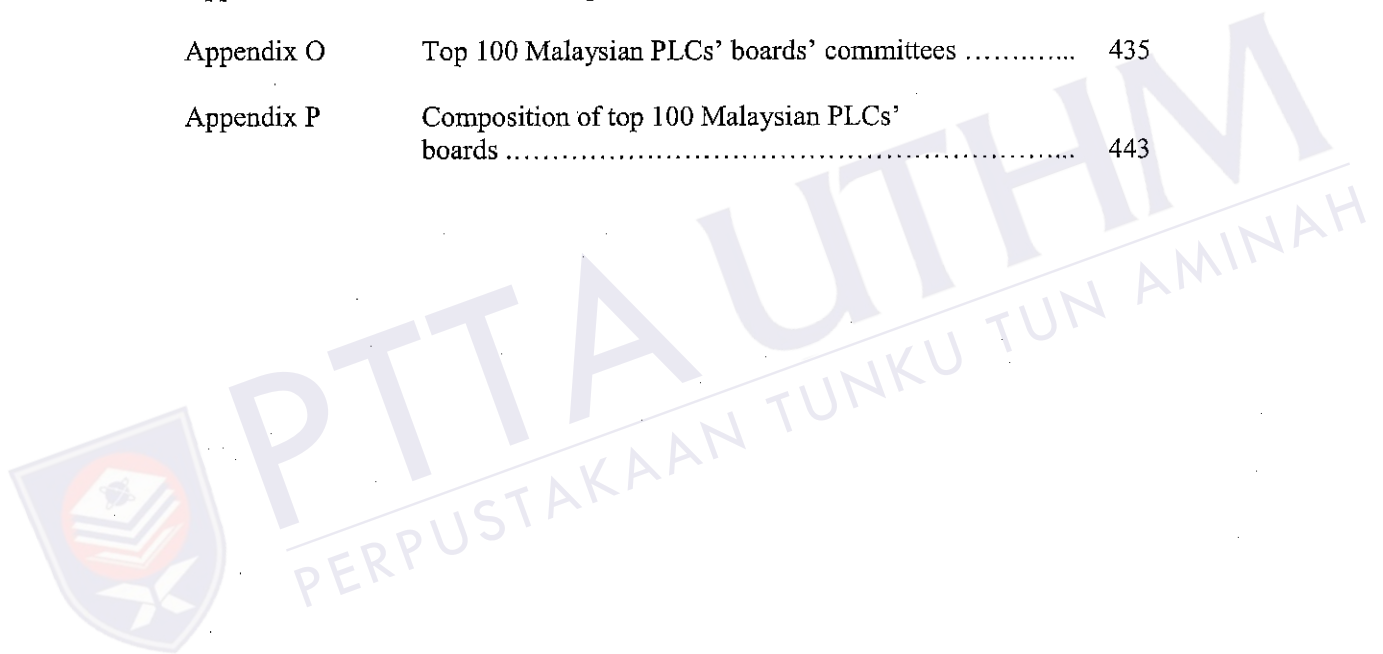
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CHAPTER 1

INTRODUCTION¹

1.1 Introduction

In dynamic business environments, the roles of both current and emerging boards of directors are under pressure as they seek to undertake challenging responsibilities. Today, boards of directors are expected to perform more than just monitoring company performance (Finegold, Benson & Hecht, 2007). They need to provide strategic advice and help manage a firm during a crisis (Daily, Dalton & Canella, 2003). In ensuring that they perform the above roles effectively, a number of scholars have acknowledged the importance of competent board members who can contribute intelligently towards the sustainability of firms' functions (Forbes & Milliken, 1999; Carpenter & Westphal, 2001; Carter & Lorsch, 2004; Leblanc & Gillies, 2005; Huse, 2005; Levrau & Van den Berghe, 2007a). Due to the importance of members of boards of directors, it is vital to identify the characteristics that make them effective. As Coulson-Thomas (1992) urged, for these reasons the attitudes and behaviours of directors are of more than academic interest, with Leblanc (2003) pointing out that their impacts are likely to influence corporate morale and, in turn, overall performance. In addressing this issue, the present study focuses on investigating the characteristics of members of boards of directors and their effectiveness in achieving company objectives within the top 100 Malaysian Public Listed Companies (PLCs).

¹ Part of this chapter has been reworked into a conference paper and presented at the Entrepreneurship and Management International Conference (EMIC), 5 to 7 December 2007, Putra Palace Hotel, Kangar, Perlis, Malaysia, and published in the conference proceedings by MEDEC and FBM, and Universiti Teknologi MARA, Perlis, Malaysia.

The present chapter provides an overview of the study covering seven sections as follows:

- 1.2 The importance of boards of directors
- 1.3 Context of the study
- 1.4 Motivation for the study
- 1.5 Significance of the study
- 1.6 Operational definitions
- 1.7 Organisation of the thesis
- 1.8 Summary

1.2 The Importance of Boards of Directors

Company boards of directors are bodies entrusted with power to make economic decisions affecting the well-being of investors' capital, employees security, communities' economic health, and executive power and perquisites (Banks, 2004). Hence, boards of directors have the ultimate internal authority within a company (Renton, 1994).

The history of boards of directors came to the forefront of corporate life in the mid-eighteenth-century in Britain, when the state or the crown created them to ensure business stability (Tricker, 1984). Prior to that time, the only way to do business was as a sole trader or partnership. Within this simple structure, when a business became insolvent, the owner and family held all liabilities (Tricker, 2003). When the concept of joint-stock limited companies with separate legal entities between the owner and the company (called 'separation of ownership and control') was introduced, the owner or shareholders were able to elect a manager of a firm (Garratt, 1997). The owners of such firms were no longer responsible for managing their firm's operations on a daily basis. Rather, daily operations were in the hands of the firm's team of professional managers (Taschler, 2004).

The progression from control by owners to control by managers was first analysed by Berle and Means (1932), leading to what has become known as the 'agency theory' (Jensen & Meckling, 1976; Fama & Jensen, 1983). Agency theory argues that the separation of ownership and control in modern corporations has resulted in a potential conflict of interests between the owners and their managers, in which managers may seek to act in their self-interest rather than the interest of the shareholders. Westphal and Stern (2007) added that in many instances firm managers could use their knowledge and managerial expertise to gain advantage over the firm's owner. Furthermore, Ezzamel and Watson (2005) argued that with growth in business size and complexity of operations, shareholders are not able to monitor their firm's managers. Abbas (1990) suggested that one way to resolve this problem is to align the interests of both shareholders and managers. To do this, shareholders need to appoint boards of directors to represent them to oversee the firm (Monks & Minow, 2001). Their appointment is based on the assumption that each of the board members is fully accountable for their actions on behalf of the owner (Garratt, 1997).

In the literature, most definitions see boards of directors as groups of individuals elected by shareholders of corporations to oversee companies (Abbas, 1990; Donaldson & Davis, 1994; Bainbridge, 2002, 2008; Abdullah, 2004; Kemp, 2006) and to ensure that the corporation is managed effectively (Young, Stedham & Beekun, 2000). Due to the important role of boards of directors in modern corporations, legal requirements for incorporation typically state that a board of directors is set up to meet specific legal requirements when acting on behalf of shareholders in the firm's decision-making (Ezzamel & Watson, 2005; Adams & Ferriera, 2007). Board members, therefore, carry out various legal obligations to perform their fiduciary duties² in the best interests of shareholders (Afterman, 1970; Andarajah, 2001; Sulaiman, 2001). Such duties include hiring and firing of the CEO and top management (Hermalin & Weisbach, 2002); providing strategic directions (Walt & Ingley, 2001; Kemp, 2006); and assessing resources (Hillman,

² Their duties are as trusted agents who represent shareholders' interests (Banks, 2004). The directors as fiduciaries of the corporations pledge to adhere to standards of conduct, which do not deplete the assets or earnings of the company (Berle & Means, 1932).

Canella & Paetzold, 2000). In these ways, the board's success in discharging its duties directly influences shareholder values (Abdullah, 2004).

In the growth of reliance on boards of directors to bring stability to large businesses from the 1950s to the 1970s, boards of directors were not seen as a crucial part of the corporate governance process, because, at that time, the board was only part of a CEO's team (Banks, 2004). Earlier researchers (e.g. Mace, 1971; Vance, 1983; Monks & Minow, 1991) claimed that earlier boards were passive, compliant and unproductive, and made little contribution to a firm's strategies. Banks (2004) argued that these boards were often more for status than overseeing the welfare of the business. Board members also tended to be 'yes men' (Stiles & Taylor, 2001), generally providing 'rubber stamp' approval of virtually every matter requiring a decision (Banks, 2004). In this situation, CEOs played the dominant role in company decision-making (Hamilton, 2000). This pattern remained relatively unchanged until an awareness of corporate governance began to develop in the 1970s.

In the years following the above developments, boards of directors have become increasingly complex. Many scholars have argued that globalisation of economies and rapid advances in information technology have presented potent challenges for boards (Conger, Lawler III & Finegold, 2001; Cadbury, 2002; Keil & Nicholson, 2003; Carter & Lorsch, 2004). For example, Conger et al. (2001) and Dalton and Dalton (2005) felt that globalisation has led to sharp increases in the numbers and types of businesses. This has now led to many boards facing enormous challenges in dealing with their global business and operating in diverse governance and cultural situations (Gevurtz, 2002). For example, Arewa (2005) stated that the new corporate culture was also relevant in shaping how boards of directors confront the challenges that a particular business environment may pose. Although their links to a corporation may be remote, they still have to protect the long-term competitiveness of their company (Alfonso, Jikich & Banez, 2005).

In addition, rapid advances in information technology and the Internet have changed the business environment (O'Brien & Robertson, 2009) and the roles of boards. For example, the Internet has become a major business tool, which makes the timeframe for decision-making shorter and faster (Wilson & Lombardi, 2001). As a result, Conger et al. (2001) urged that speed in action is critical to the effectiveness of the board. At the same time, as more corporations use the Internet to disseminate their financial information, the public is now able to gather more information about corporate performance (Xiao, Jones & Lymer, 2002). The ease of access to Internet stock trading has thus enabled more individuals to become shareholders of corporations (Taschler, 2004). This has led to many corporations having large and diverse types of shareholders. In effect, company governance has become more complex than ever before. In these ways, information technology has changed the functions of boards, creating situations that have never been faced before. Banks (2004) argued that if boards are unaware of the impact of technology development, especially concerning the technical aspects of business, they are unable to query or challenge company management effectively.

Given such unprecedented change, many scholars assert that demands and expectations are increasingly being placed on boards of directors, especially in assessing corporations dealing with massive transformations in a global economy (Hillman, Keim & Luce, 2001; Ingley & Walt, 2003). These impacts were discussed earlier by Garratt (1997) in his book *The Fish Rots from the Head*. He urged that in the new business environment, board roles extend far beyond taking care of shareholders' interests. The board instead has to be:

- i. a driver of company business while keeping it under prudent control;
- ii. sufficiently knowledgeable about company activities;
- iii. sensitive to various pressures; and
- iv. focused on the commercial needs of the company while taking care of other stakeholders including employees, business partners and society.

In consequence of this argument, Carpenter and Westphal (2001) maintained that the persistent challenges faced by boards of directors today are to bring

meaningful contributions to corporate strategy and performance. Stiles and Taylor (2001) argued that boards today are called on to choose strategic and tactical initiatives to address emerging opportunities and challenges under circumstances in which the ultimate outcomes of decisions are largely unpredictable. To face these new challenges, boards will need to include individuals with requisite skills of a world-class standard (Coulson-Thomas, 2008). For example, in an earlier study Moran and Riesenberger (1994) suggested that in global economics, leaders should have a global mindset and diverse backgrounds. These include: having a long-term orientation; facilitating organisational change; creating learning systems, motivating employees to excellence; negotiating conflicts; managing skilfully the foreign employment cycle; leading and participating effectively in multicultural teams, understanding their own values and assumptions, accurately profiling the culture of others, and demonstrating knowledge of, and respect for, other countries. Hence, it is becoming clear that boards of director characteristics of the past will no longer be adequate in today's environment. Rather, the emerging business environment now demands a new set of leadership skills that require various leadership competencies and which are realigned towards the future of the company (O'Brien & Robertson, 2009)

1.3 Context of the study

Malaysia is one of the most successful non-western countries to have achieved a relatively smooth transition to modern economic growth during the last century (The World Bank, 2005a). In terms of the global competitiveness index³ 2006/2007, Malaysia was ranked (number) 26 of 50 countries (World Economic Forum, 2008). Since independence in 1957, Malaysia has moved from an agriculturally-based economy to a more diversified and export-oriented economy that includes consumer products, electrical and electronic goods and agricultural products (Economic Planning Unit, 2006). As a result of recent economic

³ Global competitive index 2006/2007 – 1) Switzerland, 2) Finland, 3) Sweden, 4) Denmark, 5) Singapore, 6) USA, 7) Japan, 8) Germany, 9) Netherlands, 10) UK, 11) Hong Kong, 12) Norway, 13) Taiwan and China, 14) Iceland, 15) Israel, 16) Canada, 17) Austria, 18) France, 19) Australia, 20) Belgium, 21) Ireland, 22) Luxembourg, 23) New Zealand, 24) Korea Rep, 25) Estonia and 26) Malaysia.

development, Malaysia has made significant progress towards achieving advanced country status underpinned by strong economic growth (6.0% of Gross Domestic Product (GDP) in 2006) and which is comparable with that of other developed countries such as Korea, Singapore and Taiwan (International Monetary Fund, 2007). This was to a great extent due to the rapid expansion of the capital market of Malaysia. In 2008, the Malaysian capital market turnover reached a total capitalisation of Ringgit Malaysia (RM) 877 billion (AUD 370 billion). This contributed 4.5 per cent of the 5.5 per cent of the Malaysian GDP (Economic Planning Unit, 2008).

The success of Malaysia's economic development has been widely acknowledged to have resulted from various government efforts (Yaacop, 2004), in which the government has maintained macroeconomic stability and growth by providing prudent economic and fiscal policies relating to trade, competition, regulations, financial systems, capital markets, and technology and innovation, (Economic Planning Unit, 2007). For instance, in the Ninth Malaysia Plan the government focused on strengthening existing economic sectors and generating new knowledge-intensive activities in information and communications technology, biotechnology and the services sector. This plan provides a blueprint of strategies and programmes that are geared towards realising the economic and social objectives of the country. Part of this plan is to strengthen corporate governance in Malaysia.

In relation to corporate governance, unlike developed countries including the USA, UK and Australia, Malaysia has been characterised by an insider system of corporate governance with high levels of ownership concentration, crossholdings and significant participation of owners in management (The World Bank, 1999; 2005a; Cleassens, Djankov & Lang, 2000; Khatri, Leruth & Piesse, 2002). The World Bank (2005a) reported that in more than half of Malaysian PLCs, the five largest shareholders own 60 per cent or more of company equity. The largest shareholder groups among the top five shareholders in Malaysia are nominee companies (45.6%), followed by non-financial companies (25.1%) and the government (17.2%). The majority of nominee shareholdings are owned by

family enterprises (The World Bank, 2005a). Further, within the top 20 per cent, 85 per cent of Malaysian PLCs have owner-managers (Cleassens, Djankov & Lang, 2000). With this structure being widespread, the major shareholders control most companies' decision-making, including the appointment of board members (Dogan & Smyth, 2001; Gomez, 2005; On Kit & Tan, 2007). As a result, the characteristics of board members of Malaysian PLCs have been found to be quite diverse. Further reports of Malaysian corporate governance and boards of directors are presented in Chapter 3.

1.4 Motivation for the study

This study was conceived at a time when directors' accountability in Malaysia was considered an important issue in the improvement of Malaysian corporate governance. For example, in 2000 the Malaysian Code on Corporate Governance (MCCG) placed the responsibility for sound governance on the boards of directors. Part 2 AA III of the MCCG (2000, p.10.) specifies that:

Non-executive directors should be persons of calibre, credibility and have the necessary skills and experience to bring an independent judgement to bear on the issues of strategy and performance including key appointments and standards of conduct.

Here, MCCG recommended that Malaysian PLCs should have well-balanced and effective boards of directors that are both credible and independent. Khoo (2003) argues that as the code fails to specify good characteristics of board members (e.g. experience, qualifications and relevant competencies), the appointment of the majority of Malaysian PLCs directors, particularly outside directors, has been determined by top management self-interest (Tan & Sendjaya, 2007). It was found that the appointment of the majority of non-executive independent directors of Malaysian PLCs was based on personal contact, either with the chairman or with the CEO (PricewaterhouseCoopers & KLSE, 2002). This has led to about 85 per cent of board members in Chinese-owned companies in Malaysia consisting of their family members (Khoo, 2003). In contrast, the board members of government-linked companies come from diverse backgrounds

including distinguished ex-civil servants, specialists and other knowledgeable persons (Khazanah Nasional, 2006).

The importance of characteristics of members of boards of directors has been the subject of an extensive body of research. A number of scholars have identified the importance of directors' demographic backgrounds, including age, tenure, experience and gender, to the effectiveness of the board and firm performance (e.g. Hambrick & Manson, 1984; Wiersema & Bantel, 1992; Westphal & Milton, 2000; Vafeas, 2003; Smith et al., 2006; Campbell & Manges-Vera, 2008). In addition, Carter and Lorsch (2004) claimed that the majority of members of boards of directors are incompetent, but offer no specific supporting evidence. More recently, Levrau and Van den Berghe (2007b) looked more closely at directors' qualities and revealed that directors' personalities, education, occupational and functional backgrounds are important for the effectiveness of boards. These findings imply that the characteristics of members of boards of directors provide valuable insights into board and into firm performance.

Although the characteristics of board members have been extensively studied in developed countries, limited research has been undertaken on this topic in Malaysia. Nevertheless, a study conducted by Haniffa and Cooke (2002) revealed that three board members' characteristics (ethnic backgrounds, composition and multiple directorships) were significantly related to corporate social disclosure among Malaysian PLCs. Specifically, PLCs boards dominated by Malay directors significantly increased the levels of corporate social disclosure. However, no study to date has examined the influence of board members' personality characteristics and competencies in Malaysia.

Based on the above-mentioned knowledge gap, the aim of this study is to examine the characteristics of members of boards of directors and to determine the contribution that these characteristics make to the effectiveness of the boards of Malaysian PLCs. Hopefully, such an examination can add to the growing body of research in this area, particularly in providing evidence from a developing capital-market economy. Specifically, this study aims to determine:

- i. characteristics of effective directors in Malaysia;
- ii. characteristics of effective chairman,⁴ CEOs, and independent directors in Malaysia;
- iii. characteristics of effective boards in Malaysia; and
- iv. whether the characteristics of board members are congruent with board effectiveness of Malaysian PLCs.

Given the significant developments in corporate governance in Malaysia and the potential for anomalies in the characteristics of members of boards of directors in the less developed capital market of Malaysia, the conclusions drawn from this study are supported by secondary data as well as by empirical evidence from interviews with the directors of 41 of the top 100 Malaysian PLCs.

1.5 Significance of the study

This study contributes to the emerging interest in boards by examining the characteristics of members of boards of directors and to the development of an effective board. It is envisaged that this study will determine the relevant characteristics of Malaysian PLCs boards of directors, both individually and overall, in five ways.

First, as all boards are unique yet in some ways alike, their efficacy may vary depending on a range of components. However, in determining effective boards, Leblanc (2003) and Roberts, McNulty and Stiles (2005) argued that board members' characteristics are more important than the structure or composition of the board. Similarly, Ricart, Rodriguez and Sanchez (2005) contended that boards of corporations should comprise individuals with the requisite skills, values and connections, which enable them to sustain corporate business. Following the above arguments, the results of this study should contribute to the interests of both academics and business practitioners by developing an in-depth understanding of the demographic backgrounds, personality characteristics and values, and competencies of corporate leaders including individual directors,

⁴ Chairman include male or female or singular or plural

chairman, CEOs and independent directors. These results are expected to further inform corporate decision-makers in other contexts that have similar characteristics to Malaysian firms.

A second contribution that stems from this study of boards of directors is its use of a qualitative approach. In spite of the intense research interest in boards of directors in Malaysia, most studies have largely utilised a quantitative research approach (e.g. Haniffa & Cooke, 2002; Abdullah, 2004, 2006; Rahman & Haniffa, 2005; Haniffa & Hudaib, 2006). Therefore, a qualitative study on the characteristics of members of boards of directors in Malaysian companies can provide a different perspective and reduce the observed gap in research by studying the characteristics of members of boards of directors and board effectiveness in Malaysia. This expands upon similar work by Leblanc (2003) and Levrau and Van den Berghe (2007b). In particular, the present study adds to the body of knowledge by demonstrating the value of using a qualitative methodology in corporate governance research.

Third, much of the existing research on members of boards of directors has focused on western countries' corporations and governances (particularly the US, the UK and Australia). As studies of members of boards of directors in the Malaysian context are still limited, the present study contributes to the body of knowledge in this area by taking another perspective through examining Malaysian PLCs' boards.

Fourth, this study addresses Malaysian public policy issues concerning the characteristics of members of boards of directors and board effectiveness in Malaysia. Therefore, this study should contribute to a better understanding of the general and specific characteristics of boards of directors in Malaysian PLCs, and is particularly useful for assisting nomination committees choose the best criteria when appointing their board members.

Finally, the results of this study should contribute information about the characteristics of effective boards that can be used by Malaysian regulators in

formulating corporate governance policies in Malaysia. Ultimately, this study may contribute to the overall enhancement of Malaysian corporate governance.

1.6 Operational definitions

As there are certain terms for which there are various definitions, this section defines the key terms as they apply in this study. These comprise:

1.6.1 Characteristics

In this study, characteristics refer to three aspects of board members as follows:

i. Demographic characteristics

Demographic characteristics include age, gender, ethnic group, tenure and number of directorships (Hambrick & Manson, 1984; Zahra & Pearce, 1989; Westphal & Milton, 2000).

ii. Personality characteristics and values

Psychological characteristics and values include commitment, integrity, courage, confidence, ability to lead, being consensus builders, and being challengers (Hambrick & Manson, 1984; Coulson-Thomas, 1992; Milliken & Martins, 1996; Leblanc, 2003; Yulk, 2006).

iii. Competencies

Competencies refer to individual capabilities or abilities to perform particular roles (Boyatzis, 2008). These include knowledge and skills, educational qualifications and industry experience (Hambrick & Manson, 1984; Coulson-Thomas, 1992; Milliken & Martins, 1996; Forbes & Milliken, 1999, Conger et al., 2001).

1.6.2 Members of boards of directors

In this study, members of boards of directors refer to any individuals who work jointly with fellow directors on a board (Wallance & Zinkin, 2005). These include chairmen, CEOs and independent directors who have the same legal responsibilities despite performing different functions (Rachagan, Pascoe & Joshi, 2002).

1.6.3 Board effectiveness

Due to the lack of one general academic definition describing board effectiveness, in this study board performance refers to board effectiveness, since both terms have been used interchangeably (Levrau & Van den Berghe, 2007a). However, as many exogenous factors influence board effectiveness, in this study board effectiveness has not been examined in terms of financial performance. Instead, board effectiveness has been assessed by reference to how participants perceive their overall boards, particularly the internal perspective of boards of directors (board structure and composition, board process and individual directors); and external aspects of boards of directors (legislation and economic situation). Thus, board effectiveness in this study will be determined by the directors' perception of the optimum board level, not anything less (Leblanc, 2003).

1.6.4 Malaysian Public Listed Companies (PLCs)

Malaysian PLCs refer to the public listed companies registered in Malaysia and listed on the first board of Bursa Malaysia Berhad (Bursa Malaysia, 2008b).

1.7 Organisation of the thesis

This thesis is organised into nine chapters as follows:

Chapter 1 (Introduction) covers the importance of boards of directors, the context of the study, motivation for the study, significance of the study, operational definitions and the organisation of the study.

Chapter 2 (Literature Review on boards of directors) includes board effectiveness, the influence of the various board attributes on board effectiveness, and characteristics of boards of directors' members. This chapter also describes the evidence from previous studies on the importance of the boards of directors' members. Five theories including upper echelon theory, trait theory, resource dependency theory, agency theory, and human and social capital approach are discussed in this chapter.

Chapter 3 (Corporate governance in Malaysia) provides a brief history of the Malaysian national and economic setting, the New Economic Policy (NEP) and corporate ownership control in Malaysia, concentration of ownership in Malaysia, corporate governance development in Malaysia, the Malaysian corporate governance framework and boards of directors in Malaysia.

Chapter 4 (Theoretical framework) provides justification for the framework of this study to enable the development of six research questions. These questions are formulated to investigate issues relating to the objectives of the study.

Chapter 5 (Research design) justifies the qualitative research design used in this study. In addition, the research strategies and data collection process including interview procedures and data analysis process are discussed. The last section discusses the rigour of the study.

Chapter 6 (Results 1 – Characteristics of members of boards of directors) reports on the data collected from annual reports and interviews. Four categories of characteristics of board members are reported: directors' characteristics, chairman's characteristics, CEOs' characteristics and independent directors' characteristics.

Chapter 7 (Results 2 – Characteristics of effective boards) reports on the characteristics of effective boards in Malaysia.

Chapter 8 (Discussion) presents a discussion of the study results in relation to relevant theories and empirical studies, as well as to Malaysian corporate governance scenarios.

Chapter 9 (Conclusion) concludes the study and discusses its contributions and limitations. Suggestions are made to future researchers engaging in the study of boards of directors.

An overview of the study showing the inter-relationships of the nine chapters is shown in Figure 1.1 below.



PTTA UTHM
PERPUSTAKAAN TUNKU TUN AMINAH

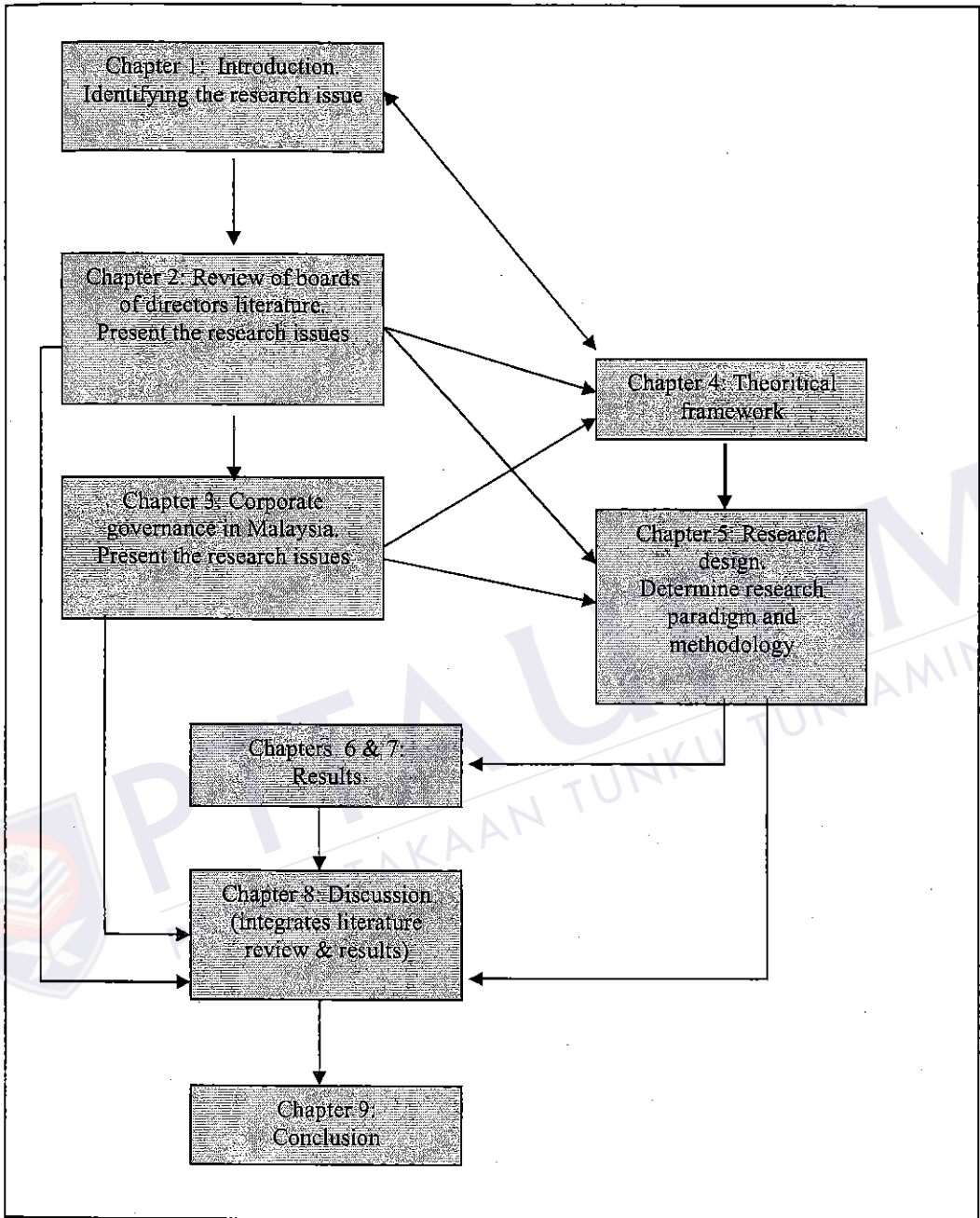


Figure 1.1: Organisation of the thesis

1.8 Summary

This chapter has laid the foundation for the study by introducing the importance of boards of directors, the context of the study and motivation for the study. This chapter has also summarised the significance of the study and the operational definitions used. The following chapter provides a review of the literature relevant to understanding the context of the study.



CHAPTER 2

LITERATURE REVIEW ON BOARDS OF DIRECTORS

2.1 Introduction

With the corporate failures of the last decade, both academic and financial practitioners have begun to recognise the importance of boards of directors to corporate governance. The roles of boards of directors are challenging as they seek to discharge a diversity of roles and responsibilities in a dynamic business environment. Boards are expected to perform a variety of functions including monitoring of management to mitigate agency cost (Fama & Jensen, 1983; Johnson, Daily, & Ellstrand, 1996; Dallas, 2001; Harris & Raviv, 2004), providing and giving access to resources (Preffer & Salancik, 1978; Hilman & Dalziel, 2003) and providing strategic direction to the firm (Tricker, 1984; Conger & Lawler, 2001; Kemp, 2006). Carpenter and Westphal (2001) urged that a board should be studied as a team of individuals who combine their competencies and capabilities and contribute towards executing a company's governance. Given the increasing importance of the individual members of boards of directors, it is important to identify the characteristics of board members that make one more effective than another.

This chapter provides a review of theoretical and empirical studies on boards of directors. It serves the purpose of demonstrating a diversity of approaches to studying boards of directors and the importance of studying the characteristics of such boards. This chapter is organised into three parts:

- 2.2 Board effectiveness
- 2.3 Characteristics of members of boards of directors
- 2.4 Summary

2.2 Definition of organisational effectiveness

Organisational effectiveness is not a simple concept as each organization is different (Thibadeaux & Favila, 1996). The literature observations from earlier studies on organisational effectiveness bring about several meaningful views by scholars. Generally, organisational effectiveness (OE) is conceptualised in terms of understanding an organisation as a “measure of worthiness” for taking part in “society’s resources” (Armstrong, 1994; Federman 2006).

Historically, organisational effectiveness has been defined in relation to outcomes or goals. For example, an earlier scholar (Price, 1968) measured effectiveness based on the goal attainment approach. Within this approach, effectiveness was evaluated from what the organisations were trying to do, and he defined effectiveness only if operative goals were clearly articulated. He also suggested five variables (productivity, conformity, adaptiveness and institutionalism) that can be used to measure organisational effectiveness. Although this approach is relevant until today, it was argued that in the goal approach the casual associations between certain predictor variables and effectiveness have never been empirically demonstrated because organizational effectiveness relies on more than one factor (Cameron, 1986). The above argument shows that it is not easy to determine organisational effectiveness based entirely on goal achievement.

Later, a number of scholars developed broader scopes of organisational effectiveness. For example, based on a literature review of performance measurement, Kanter and Brinkerhoff’s (1981) made a distinction among three kinds of effectiveness as follows:

- i. Task effectiveness or goal attainment, including output, results and efficiency;
- ii. Appropriate organisational structure and process, including organisational characteristics, member satisfaction, absence of strain between subgroup; and

- iii. Environment adaptation, including flexibility in the face of change, longer-term adaptation and survival.

They concluded that effectiveness appeared to be a political rather than a specific concept as the new models of organisations had moved away as a result of environmental, economic and political changes. In agreement, Federman (2006) believes that such assessments can reflect the creation of a complex environment within which the organisation exists and interacts; the organisation can reconceive its theories of action by balancing four primary competing values – focus, structure, outcomes, and orientation.

Despite these factors, Redshaw (2001) suggests that effectiveness can be better evaluated if the components or entities are broken down into 'workable fields'. According to Redshaw (2001), if the business process or functions that will bring about improvements in the organisation are identified, then the indicators for success (as identified by managers) can be linked to the objectives for the business functions. The broken down workable fields suggested by Redshaw (2001) are increasing resourcefulness and improving internal processes (internally), and achieving goals and satisfying clients (externally).

- i. Internal indicators of organizational effectiveness implies that improving internal processes based on hard data such as labour turnover, motivation and teamwork brings better functioning of internal process, which is associated with an organisation's process.
- ii. External component requires organisations to have clearly defined processes, goals and planning to be able to realize their effectiveness. According to Redshaw (2001), this means that an organisation has broadened its market base, increased production capacity, improved production economy and increased its ability to respond to changes.

The above reviews show that the terms 'effectiveness' and 'performance' are used interchangeably because their definition, measurement and explanation are virtually identical. Therefore, some of the indicators of effectiveness found in the literature are; quality of services or product, employee satisfaction, employee

withdrawal (Lunthaus et al., 2000), growth indicators in terms of profit or rate of return on investment (Steer, 1997). For example, if organisational effectiveness is defined in terms of its degree of financial achievement, it is obvious that achieving high financial performance becomes the main criteria for measuring effectiveness (Armstrong, 1994). More importantly, it has been argued that the organisation is called effective when it successfully achieves its purpose and objectives, while also meeting its responsibilities to its stakeholders including the owners, shareholders, public authorities, the employees, the customers, client and the community (Lunthaus et al., 2000).

Because of the various measurements of organisational effectiveness found in the literature, it can be concluded that there is no universal measurement and model of organisational effectiveness. The following sections provide evidence on the various components that can be used to measure effectiveness within the boards of directors' perspective.

2.3 Board effectiveness

2.3.1 Measuring board effectiveness

In the boardroom context, the issue of board effectiveness has been one of the most sought after yet elusive research subjects since the early development of corporate governance. Particularly, board effectiveness studies emerged as a result of a number of corporate frauds, as well as an increase in public awareness about the importance of high standards of corporate governance (Barton & Wong, 2006).

There is abundant research in the literature that examines board effectiveness. Similar to organisational effectiveness, there is no absolute board effectiveness measurement found in the literature. Early attempts to measure board effectiveness used quantitative measurements. Board effectiveness was measured as the relationship between various characteristics of boards of directors (in particular board composition and structure) and various financial performance measurements such as Return on Assets (ROA), Return on Equity (ROE),

Earnings Per Share (EPS) and Market Book Ratio (Tobin q). For example, Zahra and Pearce (1989), Yermack (1996), Dahya and McConnell (2003), Abdullah (2004), Bozec (2005) have covered aspects such as board composition, characteristics, and their impact on firm performance. The literature has identified board size, proportion of independent directors, Chair-CEO separation, board diversity, board remuneration, as the key factors that influence the effectiveness of boards.

Through the numerous changes that have occurred in the corporate environment during the last decade it was soon discovered that financial performance is no longer the only criteria to be taken into account when evaluating business effectiveness. Instead it is argued that board effectiveness is a broader construct because it captures performance plus the plethora of internal performance outcomes normally associated with more efficient or effective operations and other external measures that relate to considerations that are broader than those simply associated with economic valuation (either by shareholders, managers or customers), such as reputation (Thibadeoux & Favila, 1996). As a result, beginning year 2000 many scholars (e.g. Walt & Ingley, 2001; Leblac, 2003; Finkelstein & Mooney, 2003; Sonnedfeld, 2002; Huse, 2005, 2007; Schmidt & Brauer, 2006; Levrau & Van den Berghe, 2007b; Finegold, 2009) proposed that the overall component of the board including board behaviour in respect to strategic decision making, the teamwork of board members and their interaction with management were the most reliable indicators of board effectiveness. For example, from a qualitative research Leblanc (2003) discovered three main components of an effective board as follows:

- i. Board membership – includes the full panoply and balancing of all directors competencies and expertise
- ii. Board structure – includes board size, board composition and leadership structure
- iii. Board process – appropriate balance of directors behaviour in order to ensure effective interaction with fellow board members and management

In agreement, based on an analysis of 131 Belgian listed companies, Berghe and Levrau (2004) discovered eight elements of effective boards. These include: the

right structure, the right people (including appropriate characteristics of the chairman); the right culture; the right issues; the right information; the right process; the right remuneration; and the right follow-through. The same authors argued that although each element plays an important role in board effectiveness, some elements are more important than others. More importantly, they concluded that a board needs to have the 'right' people who can shape the right structure, culture and process of the board.

Similar to organizational measurement, it can be concluded that board effectiveness is a broader construct. Therefore, the review of different perspectives confirm the need to take an integrated approach rather than a single perspective to understand board effectiveness. To justify this conclusion, in the following sections board effectiveness is discussed from two perspectives:

- i. Internal perspective of boards of directors – controllable elements including factors associated with board structure and composition, board process and individual directors; and
- ii. External aspects of boards of directors – uncontrollable elements including external factors such as legislation and economic situations.

2.3.2 Determinants of board effectiveness – from internal perspective of boards of directors

Internal perspectives of the board are the most popular area in board effectiveness research. Five internal aspects of boards of directors (board composition, board structure, board process, board roles and board membership) are the most popular issues that have been widely researched.

Board composition and structure

In this section board effectiveness is reviewed within three perspectives; board size, a mixture of inside and outside directors; and duality of roles.

Board size. Board size refers to the number of directors sitting on the board (Levrau & Van den Berghe, 2007a). Board size has been found to vary between one country and another. For example, boards in Europe, in three countries (the UK, Switzerland and Netherlands) tend to have a small board size (fewer than ten board members), while other countries (e.g. Belgium, France, Spain, Italy and Germany) have a larger board size, i.e. between thirteen and nineteen members (Heidrick & Struggles, 2007b). In Australia, board size has an average of seven members (Korn/Ferry International & Egan Associates, 2007).

When considering the size of the board, there is a trade-off between advantages and disadvantages. Some scholars view a small board as more effective because it is easy to coordinate and tends to be more cohesive (Hossain et al., 2001; Kiel & Nicholson, 2003; Mallin, 2005). However, Conger and Lawler (2009) argued that there is no magical or ideal size for a board and the right size for a board should be driven by how effectively the board can operate as a team. Meanwhile, from the resource dependency perspective, larger boards are important to provide resources that are valuable to the firm (Pfeffer, 1972; Hillman et al., 2000; Taschler, 2004). This relationship is grounded in the view that board size is related to a firm's ability to access critical resources and the external environment (Dalton et al. 1999; Hillman et al., 2000; Hillman & Dalziel 2003). From an agency perspective view, larger boards provide effective monitoring by reducing the domination of the CEO (Fama & Jensen, 1989; Harris & Raviv, 2004). Despite the above advantages, Gabriellsson and Winlund (2000) and Conger and Lawler (2009) argued that larger boards could end up as legislative bodies rather than as working groups. In addition, Daily and Dalton (2004) assert that with a larger board it is easier for an individual director to hide metaphorically and pass the responsibility for raising provocative questions and engaging in active debate in board meetings to other directors. Conger and Lawler (2009) considered nine to 13 members to be appropriate for corporate boards.

The impact of board size on board and firm performance has been a matter of continuing debate. Some studies discovered a positive relationship between board size and firm performance. For example, Pearce and Zahra (1991) found a

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