

## APPOINTMENT AND PERFORMANCE ENHANCEMENT OF INDEPENDENT DIRECTORS IN MALAYSIA

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### **Abstract**

The objective of the study is to gauge the perception of directors in Malaysia on the appointment of independent non-executive directors and the mechanism needed in enhancing their role. A qualitative research design using a face-to-face interview is chosen in this study as it is a valuable tool in understanding the directors' opinion on the appointment and performance enhancement of independent non-executive directors in Malaysia. The directors interviewed reveal that independence, experience, knowledge of the firm, and contacts are determinants of having independent non-executive directors on the board. On the other hand, training programmes, access to information, preparation for meetings, being in committees and effective performance evaluation are necessary factors in enhancing the performance of independent non-executive directors. Due to the lack of published materials in this area in Malaysia, this study will therefore contribute to the existing knowledge on the appointment and performance enhancement of independent non-executive directors. Understanding how independent non-executive directors are chosen and the mechanisms in enhancing their performance is crucial because who gets selected will, in turn, affect the roles they play and how effectively they can play such roles.

**Keywords:** independent non-executive directors, appointment, performance evaluation, enhancing performance of non-executive directors

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### **Introduction**

The inclusion of independent non-executive directors on the board of public listed corporations has become a greatly debated issue. It is the belief that non-executive directors bring objectivity and clarity to the board in making decisions that determine the survival and prosperity of the organisations. Besides ensuring the well-being of the corporation, independent directors are also expected to champion the interests of shareholders, stakeholders, and the society at large. Being independent affords them the privilege of being able to raise issues that go beyond the profit-making concern of the organisation. However, the cases of corporate collapses such as Enron, Worldcom, Tyco, Global Crossing and many that followed have pointed to the ineffective role played by the non-executive directors on board. Similarly, Malaysia has been blemished by a couple of corporate mischief and misconduct in the case of Renong, Perwaja Steel and Malaysian Airline System (MAS), to name but a few. Recently MAS reported a RM1.26 billion net loss for the nine-month financial

year ending December 2005 against a RM216.91 million net profit previously (*News Straits Times*, March 1, 2006). The question asked was, "Where were the non-executive directors?"

In fact, previous studies in Malaysia provide evidence that the dominance of independent non-executive directors (in terms of numbers) has no significance in improving the quality of firm disclosure (Haniffa and Cooke, 2002), in mitigating earnings management (Abdul Rahman and Mohamad Ali, 2006), and in improving firm performance (Abdul Rahman and Haniffa, 2003 and Abdullah, 2004). These findings suggest that independent non-executive directors in Malaysian firms have not been effective in carrying out its independent monitoring functions. As such, questions as to what determines who get added on the board and how to stay effectively on the board has been left largely unanswered in previous studies. Thus, the objective of this paper is to view the directors' opinion on the appointment of independent directors and the mechanism needed in enhancing their performance. Understanding how directors are chosen and how to

enhance their performance is crucial to understanding corporate organisation and governance: who gets selected will, in turn, affect the roles the board can play and how effectively it can play them.

The rest of this paper is organised as follows. The next section reviews the relevant literature in the area. In addition, a presentation of the research method adopted in the study together with the results is also discussed. The final section draws conclusion from the study.

## **Literature review**

The agency theory supports the idea that outside or non-executive directors should dominate the boards so as to increase the board's independence from management. Among the arguments put forward include: to monitor and control the actions of the directors due to their opportunistic behaviour (Jensen and Meckling, 1976), to enhance the effectiveness of boards because they often try to signal that they are decision experts that can work in systems of diffuse control (Fama and Jensen, 1983), to influence the quality of directors' deliberations and decisions, to provide strategic direction and improvement in performance (Pearce and Zahra, 1992), and to remove non-performing CEO (Weisbach, 1988) and other board personnel (Pettigrew and McNulty, 1995). Non-executive directors can contribute valuable external business expertise to the affairs of the company, and they can often see risks and opportunities for the company, which might have been overlooked by the company's executives who are typically immersed in the day-to-day running of the business. Their principal role is to oversee and direct management, develop strategy, oversee implementation, approve major decisions, and serve as a resource to the company in their individual areas of expertise. It is assumed that the interests of those who invest in the company will be safeguarded by the presence of non-executives who can exercise independent judgment.

As such, the importance of non-executive directors participating in board matters has been greatly emphasised for good corporate governance. Various codes and acts on corporate governance have been issued and more emphasis is given on this matter by listing requirements around the world. For example, the Cadbury Report (1992) and the Combined Code in the UK (2003), the Bosch Report (1993) in Australia, the King Report (2002) in South Africa, the OECD Report (1999) and the Sarbanes-Oxley Act 2002 in the United States. Similarly, the Malaysian Code on Corporate Governance (MCCG, 2000) recommends, as a best practice, that there needs to be a balance on the board of directors with at least one third of the board members being independent non-executive directors. The Code and the Kuala Lumpur Stock Exchange Revamped Listing Requirements (RLR) (2002) also highly recommends that companies should set up the audit,

compensation and remuneration committees in which membership of these committees should consist wholly or a majority of independent directors. This is to ensure the effectiveness of independent outside directors in maintaining the objectivity of board decisions.

To avoid confusion with the term "outside director" used in the literature published in the US and Australia, a non-executive director in Malaysia is not a full-time director but one who attends meetings to contribute his expertise to the board. A non-executive director may not be independent in that he/she could have business and management arrangements with the corporation or other relationships including family relationships with other directors. Rule no. 9 of the Kuala Lumpur Stock Exchange (KLSE) Listing Requirements define 'independent directors' as directors who are not officers of the company, are neither related to the officers nor represent concentrated family holdings of its shares, who in the view of the company's board of directors represent the interests of public shareholders and are free of any relationship that would interfere with the exercise of independent judgment. Therefore, the independent non-executive directors must not be easily influenced by the management and their efforts must be made towards strengthening controls over management.

## **Research design**

A qualitative research design using a face-to-face interview is chosen in this study as it is a valuable tool in understanding the directors' view on the appointment of independent directors and the mechanism needed to enhance their performance. A face-to-face interview is adopted so that questions posed during the interview can be adapted when necessary, doubts can be clarified immediately (Sekaran, 2000). Similarly, Yin (1994) claims that the greatest advantage of an interview lies in the depth of information and details that can be secured.

Research for this paper began with a review of the literature. When the review was completed, a list of tentative questions was formulated. The directors of public listed corporations in Malaysia were then contacted and interviews were scheduled. Eight notable people in the private sector were interviewed using a set of similar questions, which act as a guide during the interview. Nevertheless, other questions were asked wherever necessary during the interview. The people were interviewed at separate locations, mainly at the directors' office space.

The information gathered from these interviews was combined with the information that was already published and available. While much of the information gathered during the course of the interviews confirmed that of existing literature, a lot of new information was gathered that filled in the gaps in the existing literature, thus extending and updating prior studies in several important ways.

It is difficult to provide a precise list of the questions asked at those interviews because the list of questions changed with each succeeding interview. The interviews were open-ended and usually began with a question like “How do you perceive the independent non-executive directors who are appointed on the board of directors?” The advantage of this approach is that it allowed the interviewee to talk about issues that he or she thought to be the most important and pressing rather than having the interviewer guide the direction of the interview into areas that might be of lesser importance. This technique enables the interviewer to gather information that might have been missed if the interviewer had confined herself to a strict list of questions.

### **Findings**

What emerged from the interview was the fact that a certain consensus existed on major issues and that there was not much dispute about the areas of concern or their opinions. The points gathered from the interview are listed below:

#### ***Appointment of non-executive directors***

The directors interviewed reveal that independence, experience, knowledge of the firm, and contacts are determinants of having independent non-executive directors on the board.

#### **Independence**

All the interviewees stated that the quality of independence is a serious concern for independent directors to carry out their objectives in monitoring and controlling management. However, the difficulty in defining the word independent is acknowledged by all the prominent figures interviewed. They emphasised that an independent director is a person who is able to be involved in the decision making process at the board level and come out with a correct independent judgement on the issues that have been discussed. In other words, an independent non-executive director should not be biased, one way or another.

Similar to Reiter (1999), the interviewees stressed that the issue is less about being “independent”, than it is about having the integrity, strength and realistic opportunity to express truly held views and to question management, its plan and performance. According to one interviewee, independence is in reality a nebulous concept and may change according to the state of mind of the director as he/she is faced with certain issues, and hence the onus should be on the directors themselves to have the scruples to assess their independence.

As such, they all agreed that the most important criterion in selecting an independent non-executive director is to choose a person who is independent-minded. This is judged “...from [the person’s]

character, whether he is upright” and able to think clearly in a given situation. In his personal experience, when he is involved in the selection process, one of the interviewees particularly looks for a person who is honest and experienced.

#### **Experience**

As non-executive directors can contribute valuable external business expertise to the affairs of the company, the interviewees recommended that boards of listed public companies comprise a majority of independent non-executive directors with an appropriate mix of skill and experience. In addition, their previous background in their profession might be an advantage to them as an independent director. For example, if a lawyer is appointed as an independent director, he/she may be able to look into legal issue in greater detail relative to that of a person from another discipline. Consistent with the study conducted by Lewis (2000), the interviewees agree that an independent non-executive director with a specific area of expertise can significantly share his/her expertise with the company.

The directors interviewed also suggest that people from other disciplines can be effective independent non-executive directors as long as they are willing to learn and are able to adapt their knowledge of other disciplines into the current business. For example, a person from a medical background might apply the same philosophy in medicine into business. A medical person looks at a body as a system, which consist of other subsystems. Problems in one subsystem might affect another subsystem. The same concept could be applied to a business. For example, in the concept of Balance Score Card (BSC), all perspectives are interrelated (financial perspective, business process perspective, customer perspective, and learning perspective). They are all subsystems within a system, just like in medicine.

#### **Knowledge of the Firm**

Age and qualification are not an important criteria in considering independent directors. However, all the interviewees emphasized that independent non-executive directors must have the ability to understand the laws governing business as applied by the country’s regulatory authorities, such as the Securities Commission (SC), Bursa Malaysia, and the Companies Commission of Malaysia (CCM). They emphasised that the main characteristic of a director, including that of an independent director is that she or he has a basic knowledge of the company and its industry. In addition, one of the interviewees added that an independent director must also have knowledge of the market potential of a company. Another interviewee emphasized that an independent director must have analytical skills that would be useful in making decisions. In other words, a non-executive director must understand what drives success in the firm that he/she is working in. The

views stressed by the interviewees are similar to the findings by Ford (1988) who found that a board with more executive directors has less value and importance than a board with more inside directors because of their lack of knowledge about the firm and its environment.

### **Contacts**

A majority of the directors interviewed acknowledged the fact that it is also very useful for a company to have independent non-executive directors that have contacts with specific bodies, especially the government. His view is parallel with Pass (2004), which states that non-executive directors with a background in governments and the academia can provide connections to the outside world, which can boost the status of the company and make it more respectable, hence contributing potential commercial benefits. This is especially true if the company has dealings with government linked companies or their business depends on government orders. A non-executive director with government contacts might open up doors to lots of opportunities due to the existence of networking in the government.

However, one of the interviewees was quick to claim that not every government pensioner would make a good independent non-executive director since that person might have a bureaucratic mind when it comes to following orders. In fact, some of interviewees did not consider the director's contacts as a determining factor especially in this era of knowledge economy, where it is "...not so much about whom you know, it is what you know" that matters, and that there is just no substitute for knowledge. We can therefore conclude that honesty, experience and knowledge seem to be the most important attributes in the selection of an independent non-executive director.

### ***Enhancing the Performance of Independent Non-Executive Directors***

The directors interviewed acknowledged the fact that training programmes, access to information, preparation for meetings, being in committees and effective performance evaluation are necessary factors in enhancing the performance of independent non-executive directors.

### **Training Programmes**

Those interviewed are of the opinion that independent directors should equip themselves with new knowledge by attending specialised courses so that they would play a more valuable role in the company. As such, there are training programmes (mandatory and optional) that are available to ensure that the directors can exercise their duties effectively. For example, the Bursa Malaysia Listing Requirements prescribes that directors should attend the Mandatory Accreditation Programme and the Continuing Education Programme, conducted by

various agencies such as Bursa Malaysia, the Security Commission and the Rating Agency Malaysia (RAM).

Similar to Anandarajah (2003), some of the interviewees emphasized that there should also be internal training programmes to ensure that the directors are kept up-to-date and equipped with the necessary skills to perform their duties.

### **Access to Information**

The interviewees are of the opinion that the independent non-executive directors should have access not to just historical or financial related information but also information that goes beyond assessing the quantitative performance of the enterprise, such as customer satisfaction, product and service quality, market share, market reaction, and environmental performance. In fact, one of the interviewees argued that independent non-executive directors should be encouraged and facilitated in their effort to obtain more information about the company. Another interviewee is of the opinion that the limitation to access the company's information is one of the reasons for the independent directors' low level of performance. Their independent judgment in contributing ideas and contributions to the company may be impaired if they do not obtain the information they need when making decisions.

However, one of the interviewees was quick to add that it is not necessary for the independent directors to have access to all information. They only need the relevant information, known as corporate dashboard, in making accurate decisions. Similar to the argument made by Srinivasan (2003), the interviewees are of the opinion that information overload should be prevented, as independent directors are often "tuned off" and may not read the relevant information.

### **Preparation for Meetings**

Besides understanding the annual report, the majority interviewed suggests that independent directors may even write a paper to be presented in meetings. Their opinion is consistent with that of some previous studies, which indicates that non-executive directors should provide research papers and ideas on how other companies have dealt with similar situations (CalPERS, 1998). This is particularly so in a family-owned business, where independent non-executive directors must be fully prepared to raise issues and make suggestions in influencing the decision making process and also in getting the information across to the board. Reiter (1999) argues that a truly independent director must scrutinize and question corporate activities and management proposals objectively.

Many independent directors work on a *part-time* basis. In addition to their board seats, most have very demanding careers, and are CEOs or senior executives of other companies or are very busy professionals. Many serve more than one board and

as such they do not spent much time together. In fact, some of the interviewees agree that most independent directors come to meetings without understanding the businesses. The Chairman is often frustrated with the apparent inability of these directors to absorb and remember what they have discussed at previous meetings. As such, the interviewees suggest that independent directors need a clear understanding of what drives strategic success at the company and of the major issues the company faces in order to make major decisions about their company's future. In addition, the directors interviewed suggest that board independence can be promoted by making sure that independent directors meet regularly without the management.

### **Committees**

A majority of the interviewees also highlighted that the effectiveness of independent non-executive directors in monitoring and controlling the management rely on tools such as the internal audit committee, the remuneration committee and the nomination committee. Some companies even have a financial committee and a risk management committee. These committees are responsible for looking at the "processes and procedures, including management processes, to make sure that they are in place" and report to the board should there be any areas of concern. The only thing that the independent non-executive directors have to do is to monitor these committees and act on the issues raised. If they find any problem, they would need help from the management to control it. One of the interviewees provides an example where independent directors may play their role in managing the risks of the company. "They have to assess each type of risks, for example business risks, political risks, financial risks, competitors' risks, product risks and the laws of foreign countries."

### **Performance Evaluation**

The interviewees acknowledged the fact that independent non-executive directors can contribute more effectively if there are good and transparent performance indicators to measure their performance. These indicators must be explained clearly during the induction and form an important component of the training provided to them. It is the company's responsibility to inform the board members what is expected of each of them. In fact, Srinivasan (2003) suggests that companies need to have a structured system where assessment is made by an independent third party.

However, based on some of the interviewees' experience, the normal practice in Malaysia is that independent non-executive directors conduct their own self-evaluations. Similarly, they stressed that the current practice by most companies in Malaysia is to apply the metrics concept, where independent directors themselves will evaluate where they stand and how much they have contributed. This involves

filling in a form at the end of the year and evaluating themselves against specified performance indicators. However, the results of such evaluations are not discussed among the members of the board and are left "...entirely to the conscience of the directors [to decide] if they have contributed to the company". There are no peer reviews and a majority of the interviewees cite that it is difficult to reprimand the directors since they are usually experienced people with impressive backgrounds. As Chairman, they sometimes give a few advices to the other directors, but that is as far as it goes at that level. The interviewees also disclosed that companies in Malaysia hardly terminate underperformed independent directors but will normally terminate their services if they do not attend more than 50% of the board meetings, a condition stated in the Listing Requirement.

Regarding the question of who should appraise the performance of independent directors, the most logical answer according to most of the interviewees, is the chairman. According to them, if the independent directors are not functioning, the chairman is the person who has to play the important role of remedying the situation. They stressed that "the chairman must make them work, deliver and contribute, so that the independent non-executive directors are prepared to give their independent judgment in future discussions". In many cases, most of the interviewees are of the opinion that the independent directors are just appointed to fulfil the mandatory requirements of the Securities Commission or Bursa Malaysia. One of the interviewees, in fact, suggested that a better method might be to have a structured system where assessment is made by an independent third party. This performance system could be based on set outcomes and reviewed quarterly by the chairman and an independent assessor.

### **Discussion, conclusion and future research**

The objective of the study is to gauge the perception of directors on issues related to the selection of independent non-executive directors, and ways in enhancing the performance of independent directors. The findings of the study reveal that independence, experience, knowledge of the firm, and contacts are determinants for having independent directors on the board. On the other hand, training programmes, access to information, preparation for meetings, being in committees and effective performance evaluation are necessary factors in enhancing the performance of independent non-executive directors.

In summary, all the directors interviewed are of the opinion that board independence is a necessary prerequisite for one of the board's most fundamental responsibilities: an unbiased oversight of management. They agree that independence avoids conflict of interest and dependence on the

management, as well as provides an objective perspective. There is a need of a board that is capable of taking strong independent action (and this means that the majority of directors should be truly independent) and also able to understand the company and its businesses (and this might mean having a few directors who do not pass the strictest "independence" test). If one or two of the independent non-executive directors have a deeper knowledge of the company and its industry because of prior associations that prevent them from being classified as truly "independent," their inclusion on the board could be very much in the interest of good governance. In other words, the board would be in a better position to achieve a better balance between independence and its understanding of the business.

Further, independent non-executive directors should be largely made up of not only technically sound independent directors but also psychologically independent directors. Technically sound independent directors can be confirmed through an examination of her/his past and present connections with the company. However, psychologically independent directors are more difficult to measure. In the words of one of the interviewees, "independence is actually a state of mind", while another interviewee emphasizes that the level of independence of an independent director depends on the value of each individual.

When non-executive directors are being sought, the company will be looking for the added value that a new appointment can make to the board. The added value may come from a number of facets: their experience in the industry, in the public sector, or other appropriate background; their knowledge of a particular functional specialisation (for example, finance or marketing); their knowledge of a particular process/system; their reputation; their ability to have an insight into issues discussed at the board and to ask searching questions. Of course these attributes should be matched by the non-executive director's independence and integrity.

Board independence has powerfully shaped the governance agenda hence, every aspect of a board's structure is now evaluated in light of this requirement. Thus, future research should focus on understanding the roles and tasks of the "chief executive" and whether having a CEO on the board would jeopardise the independence of the board. Due to the expectation that a new CEO will affect positive change in the organisation, future research should also examine whether CEO succession affects the firm's performance.

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