A NEW PERSPECTIVE ON BOARD COMPOSITION AND FIRM PERFORMANCE IN AN EMERGING MARKET

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Abstract

This paper seeks to examine the relationship between board composition and firm performance using a board-level aggregation variable. This study uses linear regression to analyze the relationship between board role typology and firm performance using a panel data set of 277 non-financial listed Malaysian firms over the period 2002-2007. The empirical results show that firm-boards with a high representation of outside and foreign directors are associated with better performance compared to those firm-boards that have a majority of insider executive and affiliated non-executive directors. The findings seem to imply that in widely owned firms a higher proportion of outsiders on the board reduces under-investment and agency problems, which has significant economic implications. This is the first study to use a board-level aggregation variable to demonstrate the impact of boards' resourcefulness on firm performance.

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1. Introduction

The question of board composition, in terms of who is represented on the board, has been central to many studies in the corporate governance literature. Board composition is now a broader concept, as new contingents such as environmental activists or consumer representatives have also joined the ranks and files of the corporate executives. An effective board attains the appropriate balance between the two. Outside directors are believed to be more effective monitors of management on behalf of shareholders because they are perceived to be independent. No doubt each board member has a fiduciary responsibility to serve the best interests of investors, but individual board members influence the firm in different ways as a result of their human and social capital accumulations and endowments (Davenport, 1990; Lin, 1982).

Corporate board diversity anywhere in the world can be assessed on a continuum, where at one end an insider-dominated board might be thought of as a homogeneous top management team, while at the other extreme an outsider-dominated board would be the functional equivalent of a heterogeneous top management team (Daily and Schwenk, 1996)[1]. Although substantial evidence seems to endorse the monitoring role played by outside independent directors, there are sceptics who fear that inclusion of a large number of outside directors might hinder the unity and efficiency of the corporate boards. As pressure from the institutional investors to hire outside directors is gaining momentum it has become more crucial to understand the importance of outside directors. This study is a step toward understanding the impact of board diversity on firms' performance.

Using a multidisciplinary framework, this paper derives a typology of boards and tests its impact on firms' performance. Our work is line with that of Pfeffer (1972), which indicates that outside directors are heterogeneous, and with that of Hillman et al. (2000), who suggest a classification of outside directors. We develop a