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How Independence of the Nomination Committee Impacts Firms' Financial Performance with a Mediating Effect of Board Independence

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Abstract: The Malaysian Code on Corporate Governance (hereafter, MCCG 2012) introduced on 12th March, 2012 recommended to establish an independent nomination committee for strengthening independence of the board with anticipation to improve financial performance of the Malaysian listed companies. The mandatory listing requirements of Bursa Malaysia (Stock Exchange) issued in November, 2012 also required establishing an independent nomination committee in all listed companies of the country. Regulations are supposed to improve compliance, hence it is expected that the recommendation of MCCG 2012 supported by mandatory listing requirements of Bursa Malaysia will improve independence of the nomination committee. Moreover, it is also expected that this independence will strengthen independence of the board which will improve financial performance of Malaysian listed companies. However, these expectations and postulations yet lack empirical evidences. Hence, this paper proposes to examine that how MCCG 2012 impacted independence of the nomination committee and how its independence impacted financial performance of the Malaysian listed companies with a mediating effect of board independence from 2010 to 2013 in pre and post context of the code. The proposed pre (2010-11) and post (2012-13) analysis will highlight the distinct impact of the code, if any. The proposed study will also test the anticipations of the code and Bursa Malaysia which will be a contribution to policy and literature as these have never been examined earlier.

Keywords: Corporate Governance (CG), Independent Nomination committee, Board Independence, Financial Performance, Pre and Post Analysis, MCCG 2012, Malaysian Listed Companies**.**

1. Introduction

The theory as well as practice of Corporate Governance (CG) has an underlying assumption that the separation of ownership and control had created a potential conflict of interest between management and shareholders. This conflict is known as agency problem which presumes that managers are opportunistic and protect their own interests rather those of the shareholders [1]–[4]. Therefore, agency theory and most of the CG regulations around the world consider that corporate boards have a vital role to mitigate the level of this potential conflict between management and shareholders by ensuring effective monitoring of management. However, the board can better perform this role if independent and free from the influence of management. Board independence can be judged from the proportion of non-executive and independent directors on the board. Independent nomination committee strengthens independence of the board by nominating directors who are truly independent and free from the influence of management [3]–[6]. Independent directors fortify board independence, which reduces conflict of interest between management and shareholders (OECD, 2011) [7].The boards having independent nomination committee are, therefore, considered good in monitoring and controlling (Cadbury, 1992) and Tricker, (1994) as cited in [1].

In accordance, MCCG 2012 and listing requirements of Bursa Malaysia, like Sarban-Oxley Act, 2002 in the USA and other CG regulations around the world, recommended the

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establishment of an independent nomination committee in all the listed companies of the country. The regulators anticipated that independent nomination committee will strengthen board independence, which will improve financial performance of the Malaysian listed companies. However, these anticipations are yet to prove since lack empirical evidences.

Therefore, this paper proposes to investigate that how independent nomination committee impacted independence of the board (proportion of non-executive and independent non-executive directors) and ultimately the financial performance of the Malaysian listed companies particularly after the introduction of MCCG 2012 and Bursa's listing requirements. The paper proposes to investigate the impact of independent nomination committee (as a recommendation of MCCG 2012) on firm financial performance (ROE and EPS) with a mediating effect on board independence between 2010 and 2013 in 2 year pre (2010-11) and 2 year post (2012-13) context of the code. The proposed study will not only test the anticipations of the code and Bursa Malaysia but will also fill the exhibited gap in literature with empirical evidence.

2. Literature Review

1. The establishment of independent Nomination Committee

The nomination committee has prime responsibility to nominate directors of the board. The committee ensures that the nominees are independent enough and free from management influence [8] as only independent directors can strengthen independence of the board. The renowned agency theory supports independent nomination committee on account of strengthening board independence, which improves firm financial performance. The theory posits that only an independent board can better safeguard the interests of shareholders and reduce the conflict of interest between management and shareholders [3], [5], [9]. The existence of an independent nomination committee improves firms' governance [10] which leads to firm better financial performance [6]. Subsequently, MCCG 2012 also recommended the establishment of independent nomination committees. The recommendation #2.1 of the code states that:

"The board should establish a nominating committee which should comprise exclusively of non-executive directors, a majority of whom must be independent".

The recommendation enacted on 12th March, 2012 was a soft or self-regulation based on the principle of "comply or explain" like other recommendations of the code. However, later on, the recommendation became mandatory when included in the listing requirements of Bursa Malaysia in November, 2012.Chapter #15 Part B (A), 15.08 A (1) of the Bursa Malaysia listing requirements (LR 3) describes that:

"A listed issuer must establish a nominating committee which comprises exclusively of non-executive directors, a majority of whom must be independent".

Management and CEO are not interested in independent board to monitor them. Hence, they compromise independence of directors by using their influence on the directors' nomination process. Hence, the CEO duality is considered to reduce the probability of establishing an independent nomination committee, which jeopardizes the independence of the board [11]. Stewardship theory also does not favor independence of the board by opposing the presence of non-executive and independent non-executive directors on the board. The theory negates any potential conflict of interest between management and shareholders and therefore opposes independence of the board and its nomination committee [12]–[14].

Many other studies support postulations of the theory by documenting that nomination committee has negative associations with firm performance [15], [16]. Nomination committee has no genuine work, but simply repeats whatever already carried out by the board [17]. Many empirical evidences oppose the establishment of a separate independent nomination committee [16], [17], on account of wasting time and money [16]. Moreover, the committee reduces the influence of the CEO and management on the nomination process which negatively impacts firm performance [18].

The indecisive and diverse theoretical as well as empirical evidences along with the introduction of MCCG 2012 & Bursa listing

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requirements necessitate further investigation of the relationship between independent nomination committee and board independence in Malaysia. Thus, this paper proposes to investigate the relationship on the basis of agency theory. Following are the hypothesis of the proposed study.

H1 (a): Independent nomination committee has a positive relationship with proportion of independent non-executive directors on the board before MCCG 2012.

H1 (b): Independent nomination committee has a positive relationship with proportion of independent non-executive directors after MCCG 2012.

H2 (a): Independent nomination committee has a positive relationship with proportion of non-independent non-executive directors before MCCG 2012.

H2 (b): Independent nomination committee has a positive relationship with proportion of non-independent non-executive directors after MCCG 2012.

2. Board Independence

The separation of ownership and control necessitated independence of the board. The separation of ownership was earlier discussed by Adam Smith in 1776 and then by Berle and Mean in 1932. However, the separation caught public attention after the collapse of Penn Central in the USA in 1970 when the managers started to get control of corporations [19].

The shareholders are the owners of corporation who hire managers to act as agent and look into the matters of their ownerships. The managers have access to information and firm resources while the shareholders are geographically dispersed and less informed. These in turn, weaken the control of shareholders over their ownership. Moreover, the opportunistic behavior of managers jeopardizes the protection of shareholders' interests from the expropriation of management. These issues created a conflict of interest between management and shareholders which is known as agency problem . The agency theorists consider that an independent board can control these issues and conflicts. Independent boards protect shareholders' interests by controlling the opportunism of managers. Independent boards reduce the intensity of agency problem by effective monitoring of managers which improve firm financial performance [5]. In accordance, the recommendation # 3.5 of MCCG 2012 describes that:

"The board must comprise a majority of independent directors where the chairman of the board is not an independent director."

In contrast, the stewardship theory posits that there is no tussle of interest between shareholders and management and if sometime any conflict or clash of interest arises, managers sacrifice their interests for the sake of shareholders. The theory posits that managers are stewards of the company and committed to protect shareholders' interests. They are satisfied when the firm performs well [12], [13], [20]. The majority of executive rather non-executive or independent directors maximize shareholder return and improve firm performance [21]. Independent boards have weak composition and therefore unable to ensure effective monitoring of corporate affairs. Thus, the stewardship theorists oppose the presence of non-executive directors on the board [12], [13]. They support that boards having a majority of executive directors reduce monitoring and controlling costs [22].

Theoretical postulations regarding the relationship between board independence and firm performance are not only mixed but also inconclusive. Agency theory favors while stewardship theory opposes independence of the board as well as nomination committee. The following section enlists the empirical evidences regarding this relationship.

I. *Independent Non-Executive Directors on the Board and Firm Financial Performance:*

The empirical findings regarding the impact of independent non-executive directors on firm financial performance are contradictory. For example, many studies found that the proportion of independent non-executive directors has no association with firm financial performance [23]–[25]. Firm performance has not been impacted by the proportion of independent non-executive directors on the boards in Vietnam [23]. It has been endorsed by the results of another study that there is no relation between board independence (independent non-executive directors) and firm financial performance in Sri Lanka [25].

Some studies even reported that independent non-executive directors has negative association with firm performance [26]–[28] and therefore increasing their proportion lowers firm performance [29]. These empirical findings are in accordance to stewardship theory which support executive rather independent non-executive directors on account of their superior firm and industry specific knowledge which improve firm performance [12], [13], [30].

In contrast, it is also argued that independent directors on board have positive association with firm performance [31]. More than 70 % of the East Asian companies are family owned [32] where independent directors perform better [33]. Independent directors are equally important and positively link to firm performance in both family as well as non-family owned companies [34]. Poor performing firms may improve their performance by nominating more independent non-executive directors to their boards [35]. These empirical findings support the theoretical assumptions of agency theory.

The inconclusiveness of the relationship and introduction of MCCG 2012 and Bursa Listing Requirements necessitates further investigation of the relationship in Malaysia. Hence, this paper proposes to investigate the impact of independent non-executive directors on firms' financial performance in pre and post context of the code. On the basis of agency theory, the paper hypothesizes that:

H3 (a): The proportion of independent non-executive directors has a positive relationship with a firms' financial performance before MCCG 2012.

H3 (b): The proportion of independent non-executive directors has a positive relationship with firms' financial performance after MCCG 2012.

II. Non Independent Non-Executive Directors on the Board and Firm Financial Performance

Empirical findings regarding the impact of non- independent non-executive directors on firm financial performance are also mixed and inconclusive. For example, many studies report that there is no relation between non independent non-executive directors and firm financial performance [36]–[40]. Some investigations documented that non-executive directors on the board has negative relation with firm financial performance [26], [41]. It is argued that the majority of non-independent non-executive directors weakens firms financial performance [26]. These empirical findings strengthen the theoretical postulations of stewardship theory.

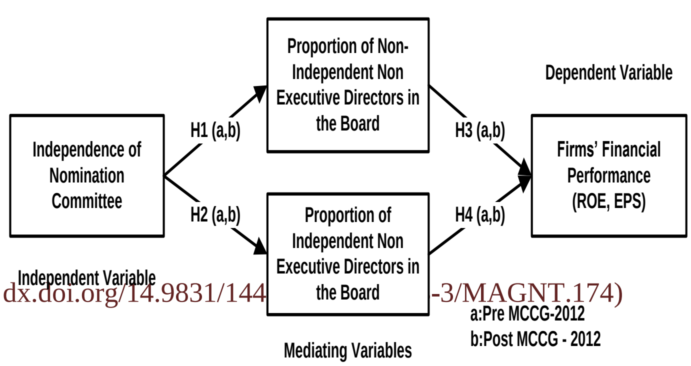
In contrast, it has also been found that investors respond positively to the proportion of non-executive directors on the board [42]. Many other investigations also documented that the proportion of non-independent non-executive directors on the board has a positive impact on firm financial performance [43], [44]. These empirical findings support the suppositions of agency theory.

The inconclusiveness of the relationship and introduction of MCCG 2012 and Bursa Listing Requirements necessitates further investigation of the relationship in Malaysia. Hence, this paper proposes to investigate the impact of non-independent non-executive directors on firms' financial performance in pre and post context of the code. On the basis of agency theory, the paper hypothesis that:

H4 (a): The proportion of non-independent non-executive directors has a positive relationship with firms' financial performance before MCCG 2012.

H4 (b): The proportion of non-independent non-executive directors has a positive relationship with firms' financial performance after MCCG 2012.

Figure 1: Proposed Conceptual Framework



3. Proposed Objectives

Following are the objectives of the proposed study.

1. To measure the impact of independent nominating committee on the independence of board (Proportion of independent non-executive directors) of Malaysian listed companies before and after MCCG 2012.

2. To measure the impact of independent nomination committee on the independence of board (Proportion of non-independent non-executive directors) of Malaysian listed companies before and after MCCG 2012.

3. To measure the impact of board independence (independent non-executive directors) on the financial performance of Malaysian listed companies before and after MCCG 2012.

4. To measure the impact of board independence (non-independent non-executive directors) on the financial performance of Malaysian listed companies before and after MCCG 2012.

4. Measurement of Firms' financial Performance

Return on equity (ROE) and earnings per share (EPS) [47], [48] are the proposed proxies to measure financial performance of the Malaysian listed companies.

5. Scope and Methodology of the Study

The paper proposes a sample size of 270 companies calculated through Raosoft online sample size calculator from a total of 823 companies listed on Bursa Malaysia (Bursa Malaysia, 31 Dec. 2009). The proposed sample size represents all sectors of the economy except banks and insurance firms due to their different governance requirements. The proposed data regarding independent nomination committee and board independence can be extracted from the annual reports of these listed companies as evidenced by previous literature [49], [50]. Financial data of the proposed study can be downloaded from DataStream or Bloomberg. This paper suggests Structure Equation Modeling (SEM) and Boot Stepping for mediation analysis of the proposed study.

6. Contribution and Significance

The proposed conceptual model of this paper is composed of two parts regarding two relationships. First is the relationship between an independent nomination committee and independence of the board which has been rarely investigated earlier. Second is the relationship between board independence and firm financial performance, which has been much investigated. Both these relationships investigated separately and produced mixed results in the past. Thus, this paper proposes to investigate the impact of independent nomination committee on firm financial performance with a mediating effect of board independence as a consolidated model in a single study which has never been investigated earlier.

Moreover, the introduction of MCCG 2012 in March, 2012 and Bursa listing requirements in November, 2012 further necessitate the investigation of these relationships to test the anticipations of the regulations. Thus, the proposed study will not only investigate the two relationships in a single study, but will also test the anticipations of enhanced soft as well as hard regulations in the shape of MCCG 2012 and Bursa listing requirements. The proposed study will not only fill the exhibited gap in the literature but will also contribute to future policy in Malaysia.

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