CHAPTER 1 INTRODUCTION

PURPOSE AND SIGNIFICANT OF THE STUDY

With the governance issues arising from the separation of ownership and control, it is very normal that the form of the relation between the performance of firms and managerial ownership has been the subject of empirical investigation, for example, Morck et al., 1988; McConnell and Servaes, 1990, 1995; Kole 1995 and Short and Keasey, 1999. The purpose of this paper is to analyse the relationship between the performance of public listed companies (PLC) and director ownership. The firm performance includes return on shareholders' equity, valuation ratio, logarithm of the firm's sales, average annual growth in sales and total debt divided by book value of total assets.

Boards of directors are theoretically appointed to represent the interests of shareholders and bridge the gap between external shareholders and managers internal to the company. The effectiveness of the board of directors as an internal control mechanism, however, is likely to be diminished as a result of its structure; in that the majority of the boards of the companies are dominated by executive directors, hence blurring the distinction between directors and management. A KLSE and PricewaterhouseCoopers (1999) survey reported that the PLC board comprised of almost all (90%) companies had two (2) or more independent non-executive directors. This is not surprising given that the KLSE requires the majority of Audit Committee members to be independent non-executive directors. It was noted that 60% of the companies surveyed separated the role of the Chairman from that of the Chief Executive Officer and/or the Managing Director.

Nevertheless, the debate continues as to effectiveness of the various board structures and it is difficult to conclude a-priori as to how the different board structure might impact upon the relationship between firm performance and directors ownership.

The study will be useful to investors and the KLSE regulatory bodies such as the Securities Commission. The findings of the report may enable them to re-evaluate and re-assess the director ownership in the PLC. As large retail investor profile and dominant shareholders are common across corporate Malaysia. (Appendix A)

HYPOTHESIS OR RESEARCH QUESTIONS

The general hypothesis examined here is the relationship between the percentage of equity shares held by directors and the performance of firms. I hypothesise the following :

H_0 : Performance of firms is non-linearly related to the percentage of equity shares held by directors.

H_1 : Better (Weaker) performance of firms is linearly related to the higher (lower) percentage of equity shares held by directors.

Given the nature of the results produced by Morck al et. Al. (1988), McConnell and Servaes (1990, 1995), Kole (1995) and Short and Keasey (1999), I test for a cubic form of the relationship between the performance of PLC and director ownership. Specifically, the model to be tested is as follows :

$$\text{Performance} = a + ß_1\text{DIR} + ß_2\text{DIR}^2 + ß_3\text{DIR}^3 + y\text{Control Variables}$$

Three variables are included in the model to describe directors' ownership :

DIR : the percentage of shares owned by directors,

DIR^2 : the square of the percentage of shares owned by directors, and

DIR^3 : the cube of the percentage of shares owned by directors.

A cubic form of managerial ownership is examined which allows the turning points to be determined endogenously.

SCOPE OF THE STUDY

The study includes sixty-nine (69) PLC quoted on the top one hundred (100) of Kuala Lumpur Stock Exchange (KLSE) for duration of 1995 to 1999. The selected firms had to be quoted on the Official List for at least a year before the date of their accounting year-end for 1995.

The interested key variables are measures of the performance of PLC and director ownership. The firm performance variables utilise commonly used accounting and market measures of the performance of PLC. The accounting based measure is the return on shareholders' fund (ROSF). The return on shareholders' fund is calculated as earning divided by total shareholders' fund. The market measure used is a valuation ratio (VAL). It is calculated as the market value of the firm at its accounting year-end, divided by the book value of equity at the accounting year-end.

A few of additional variables are included in the performance regression models to control for other potential influences on the performance of PLC. Such as firm size, firm growth and debt. The potential impact of firm size on the performance of PLC is allowed for by the inclusion of the logarithm of total sales (SIZE). I included a variable to capture firm growth (GROWTH, measured as the percentage annual change in sales, averaged over the sample period) to control for the impact of growth on the firm's performance and for potential linkages between the firm's performance, financing structure and growth. The variable DEBT (defined as the book value of total debt divided by total assets) is included to control the possibility that debt holders exert significant influence over the behaviour and operation of the firm and its management.

The ROSF dependent variable is extracted from KLSE Stock Performance Guide, others such as VAL, SIZE, GROWTH and DEBT are calculated manually based on Companies Annual Report and KLSE Companies Handbook.

LIMITATION OF THE STUDY

This paper includes the sample selected from the Top One Hundred (100) Companies ranking by listed market valuation as at 30^{th} June 1999. It therefore excludes smaller companies.

All the analysis has assumed that director ownership is homogenous in terms of its ability to influence the performance of the firm. The history and dynamics of any corporate board would tell us that such an assumption is a simplification of practice. The present assumption is the only practicable means of quantitative analysis.

ORGANISATION OF THE STUDY

The paper is structured as follows. Chapter 2 outlines the extant literature concerning the relation between the performance of PLC and director ownership. Chapter 3 details hypotheses and empirical methods. It also describes the sample and data, while the research results are presented in Chapter 4. Chapter 5 presents conclusions and summarises the findings of this paper.