The effect of insiders and business experts on firm performance

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Abstract

This study was conducted to examine the effect of different categories of directors on firm performance. The aim was to determine whether the proportion of insiders and business experts on boards is significantly associated with firm performance. The samples used included the annual reports of 200 manufacturing firms over nine consecutive years, from 2008 to 2016, resulting in a total of 1,818 firm-year samples. The annual reports were collected from Bursa Malaysia, and additional data were gathered from DataStream. All data were analyzed using descriptive analysis, correlation analysis, and regression analysis in SPSS. These analytical techniques were employed to evaluate the relationships between the research variables. The results indicate that the proportion of insiders on the board of directors has a significant negative association with firm performance. Conversely, the proportion of business experts on the board does not have a significant impact on firm performance. Therefore, shareholders should consider appointing fewer insiders to the board and placing less emphasis on the proportion of business experts. Such adjustments could lead to improved firm performance and sustainable growth.

Keywords: Firm performance, Proportion of business experts in board of directors, Proportion of insiders in board of directors.

1. Introduction

The board of directors is a group of individuals who are elected by the owners of the company to establish corporate management-related policies and make decisions on strategic issues. As the formal representatives of shareholders, they are entitled to appoint, expel, and compensate senior management teams who will manage the operative activities in the

company [1]. After hiring the senior management team, they are responsible for monitoring and supervising the performance of management, and sometimes giving advice to them, in order to ensure all the strategic decisions are aligned with the value of the firm [2].

Agency problem is always an issue of concern by the board of directors. It arises when there are conflicting interests between principals and agents or when the managers pursue their own interests at the expense of shareholders [3]. Although the agents are appointed by directors to manage the corporation, sometimes they may make decisions and execute actions based on their personal interests instead of the interests of shareholders. This phenomenon gives rise to agency costs, which include the costs of structuring, monitoring, and bonding contracts among agents with conflicting interests [4]. The problem is bothering the board of directors because its ultimate costs would be the ineffective and inefficient overall performance of the corporation. Therefore, they are expected to minimize the conflicts of interest between the residual risk bearers and the decision maker or executor [1].

Insiders, also called executive directors, are a group of directors who are current or former members of the top management team and employees of the firm or its subsidiaries [5-7]. Since insiders are directors and active employees at the same time, the public must be concerned about their ability to fulfill both sides responsibilities without any bias [8]. Therefore, the suitability of appointing insiders to boards is always questioned. As a result, insiders are typically outnumbered by outsiders on the boards of large firms [9]. However, there are no ample empirical studies disclosed that the composition of insiders will negatively influence board effectiveness. In the context of board independence and board composition, which will ultimately influence the performance of the corporation [10, 11] the appointment of employees or managers as directors on the board (insiders) would be a worthy and interesting topic to be monitored.

Apart from the agency role, the board of directors also plays a resource dependence role, which involves providing or securing valuable resources for the board and the firm [6]. They are probably able to contribute certain useful resources that may help the firm to grow or gain a competitive advantage. Other than contributing resources, boards should help to manage the corporate dependencies toward external factors and reduce the uncertainty by connecting the firm with its external environment [12]. Furthermore, Pfeffer and Salancik [13] described boards as vehicles for co-opting important external organizations. Clearly, uncertainty is a cost to the firm because it affects resource control, strategic decision-making, and basic daily operations and functioning [13, 14]. Therefore, the resource dependence role of the directors should be viewed on an equal footing with the directors' agency role, although they are distinct theoretically and practically.

This study aims to investigate the roles of insiders, current or former members of the top management team and business experts on boards, focusing on how their composition impacts board independence and overall firm performance. Specifically, the research seeks to achieve two key objectives: (1) To examine the outcomes brought by insiders to the board and how their composition influences board independence concerning firm performance. (2) To examine the outcomes brought by business experts to the board and how their composition influences board effectiveness concerning firm performance.

2. Literature Review and Hypothesis Development

Agency theory is directed at the agency relationship between two or more parties, where one party is the principal and the other is the agent [15]. Within the framework of a corporation, shareholders (principal) and managers (agent) form an agency relationship, and the agent could be anyone designated by the principal in order to act for the principal and receive a fee [15, 16]. In the relationship, agency costs, comprising monitoring costs and bonding costs, arise due to principal-agent conflict and principal-principal conflict.

Principal-agent conflict occurs when the principal cannot verify whether the agent performs appropriately according to the work delegated [17]. The agent is supposed to act in the best interest of the principal, but the agent, in reality, may not do so. Unfortunately, the principal is unable to monitor or observe the agent's actions until the outcome occurs [18]. Since the agent's effort determines the outcome, the goal conflict between parties and the difficulty for the principal to verify the agent's actions arise as problems [17]. Besides, the conflict also occurs when the principal and agent have different risk preferences, and therefore, they take dissimilar actions.

Unlike previous conflicts, principal-principal conflicts arise between controlling shareholders and minority shareholders [19-21]. Controlling shareholder is a shareholder(s) that holds adequate voting rights to influence corporate policy and membership on the board of directors [22, 23] whereas minority shareholders are the shareholders except controlling shareholders, there is a goal incongruence among the shareholder groups, and the interest diversity motivates controlling shareholders to abuse their ownership rights to reap private benefits of control at the expense of the minority shareholders [24-26]. The conflicts probably arise when there is concentration of ownership, extensive family ownership and control, business group structures, weak governance, and poor legal protection of minority shareholders [21].

Resource dependence theory describes organizations as an open system that depends on important resources, which are available from the environment [13]. Its fundamental assumption is that the behaviors of organizations will be influenced by their extent of dependence on significant resources [27]. The situation of dependency in organizations can only occur when both conditions are met: the resources are very important and there is a high concentration of control over the resources. In other words, the organization's dependency is determined by the concentration of control over resources and the importance of the resources [13]. The organizations will try to reduce others' power over them in order to lessen their own dependence, while simultaneously expanding dependence on other organizations [28].

In the resource dependence perspective, Pfeffer [12] claims that the board of directors can help firms to minimize dependence and gain resources. The board of directors plays a role as the provider of resources, including information,

skills, access to key constituents, legitimacy, expertise, administrative advice, counsel, and access to resources [29]. At the same time, the board of directors is the connector of the firm to the external environment [6, 29]. As a provider of resources, each director may bring specific extraordinary resources to the board. Therefore, the type and degree of diversity among the directors impact the firm Hillman et al. [28]. Carter et al. [30] believe there is a highly positive relationship between board diversity and firm performance because diverse directors on boards with various special resources can help increase the resources available to the management team. Although the resource dependence theory does not explicitly mention this linkage, its extension suggests that higher board diversity will help a firm perform better because more beneficial resources are accessible to the firm.

Resource-based view rests on the key point that the resources used in production are the determinants of firm performance, just as what products are [31-33] and it also argues that the resources possessed by the firm will help in achieving a competitive advantage, which then leads to superior performance [34].

On the resource-based view of a firm, two elemental assumptions are made: (1) the resources controlled by firms within an industry may be heterogeneous, and (2) the resources may be imperfectly mobile across firms, as the transportation of resources from one firm to another requires cost. [32, 35, 36]. Based on the assumptions, the model argues that rare and valuable resources can generate a competitive advantage for a firm, which will help it to achieve higher performance. At the same time, if the rare and valuable resources are not imitable, not substitutable, and not transferable simultaneously, the competitive advantage generated from these resources may be sustainable, thus the high performance may be long-lasting [31, 34, 35, 37-39]. In other words, the heterogeneity and value of the resources are fundamental and necessary conditions for sustainable advantage, but they are not sufficient unless conditions of inimitability and non-substitutability are present [35, 40].

Insiders are directors who are current employees of the company [35] and Hillman et al. [6] included are those who have served in the past (former) as active managers, employees, or owners of the firm within the scope as well. The ratio of insiders to outsiders on the board is an important indicator of board independence. An issue to be concerned about is whether a board with a high proportion of inside directors can or wants to exercise independent judgment and decision-making, especially in matters of management control [41]. Several studies provide empirical evidence for the relationship between the insiders' proportion on the board and firm performance, and they show mixed results. Vance [42] and Cochran et al. [43] posited that there has a positive relationship, whilst Schmidt [44] and Kesner [45] proposed that the corporate performance has no significant difference between boards that had a high insider proportion and those that had not. Vance [46] analyzed a board that has fewer outsiders (more insiders) will result in superior corporate performance.

Insiders are often replaced by outsiders on the board to improve corporate governance, enhance board independence, and increase board expertise [47, 48]. However, Dalton et al. [49] argue that the representation of insiders can lead to the diminution of their expertise, experience, and reputation. Insiders are involved in day-to-day corporate decisions; therefore, they are more sensitive to the organization's economic needs [50]. Clearly, insiders' proportion on the board potentially impacts corporate performance and the success of the corporation. According to this background, the study proposes the following hypothesis:

H_1: *The proportion of insiders on the board of directors is significantly associated with the corporate financial performance.*

Business experts are directors who are current or former executives in other for-profit corporations and directors who serve on other large corporate boards [6]. Their primary human capital value would be their performance as internal decision managers in other organizations [4]. As business experts, they are assumed to provide expertise and knowledge on business strategy, decision making, and problem solving as a result of experiences they gained from serving outside the organization [6]. Due to their relevant experience, they can also provide advice and counsel to the executives on internal operation matters and serve as sounding boards.

Using a random sample of 150 firms from 6 industries, Markarian and Parbonetti [51] posited that the firms that are in the complex external environment have a larger proportion of business experts on their board, with the purpose of stimulating the firm's resource-picking function. In the same study, they found that firm size has a positive relationship with the proportion of business experts on the board. The larger the proportion of business experts, the more valuable the advice and counsel can be captured. Therefore, it is expected that business experts will have an impact directly or indirectly to the board and the firm, leading to the second hypothesis:

H_2: *The proportion of business experts on the board of directors is significantly associated with the corporate financial performance.*

3. Materials and Methods

3.1. Research Design

The study is conducted to identify if there is an existence of a relationship from the board of directors in terms of the proportion of insiders and business experts on corporate performance. Therefore, the research adopts a quantitative explanatory approach that requires numerical and statistical data to study their relationship. Since a set of hypotheses is formulated for the dissertation, and it needs to be either supported or rejected, the approach adopted will be deductive.

3.2. Source of Data

In this study, secondary data will be used. The data are gathered from the annual reports of Malaysian listed manufacturing firms. Since all the companies are listed on the Malaysian stock exchange market, their annual reports are

available at Bursa Malaysia. The official website of Bursa Malaysia is very user-friendly; therefore, it is very convenient to collect data regarding annual reports of the listed companies, stocks, commodities, securities, economic indicators, and more. The list of listed companies, which is also available, will help to facilitate the process of data collection. Additionally, further information about the financial performance of these companies is collected from DataStream.

3.3. Sample

The research studies the corporate performance of Malaysia-listed manufacturing firms. All the companies sampled are on the list of listed companies in Bursa Malaysia and are manufacturing firms in the industrial product industry, based on industry definitions by Bursa Malaysia. After the sampling process, a total of 202 firms qualified, and their annual reports for nine consecutive years from 2008 to 2016 were selected as the sample in this research. This results in 1,818 firm-year samples in total.

3.4. Measurement

Statistical Package for the Social Sciences (SPSS) will be used to analyze the data and test the set of hypotheses that are formulated in this study. Descriptive statistics and correlation analysis are adopted to evaluate and analyze the data. Descriptive statistics are used to explain the strength and direction of the relationship between the variables. It involves means and standard deviations. Additionally, correlation analysis helps to justify and measure the relationship between these two variables. As a result, both methods are essential to indicate the relationship between the board of directors and the corporate performance of that corporation in this study. Table 1 discloses the variables in this study and their means of measurement.

Table 1.
Variables and Measurements.

	Variable	**Measurement**	**Reference**
Dependent	Firm Performance	Tobin Q	Goh and Rasli [52]
Independent	Proportion of Insiders	Ratio of the executive	Hillman et al. [6]
	Proportion of B. Experts	Ratio of business experts	Hillman et al. [6]
Control	Capital Structure	Debt to total assets ratio	Fei Goh et al. [53]
	Firm Size	Book value of total assets	Fei Goh et al. [53]

4. Results and Discussion

4.1. Descriptive Analysis

In the purpose of testing the information, the descriptive statistics of the variables comprising the mean, standard deviation, minimum, and maximum data are gathered. The information for each of the variables is presented in Table 2.

Table 2.
Summary of Descriptive.

Variables	**Mean**	**Std. Deviation**	**Minimum**	**Maximum**
Log MtB	-0.2230	0.2879	-3.4470	3.8405
P. of Insider	0.3874	0.1685	0.00	0.8571
P. of Bus. Experts	0.6704	0.2459	0.00	1.0000
Capital Structure	0.2058	0.1878	0.00	2.5387
Firm Size	787902545	2665628708	0	42235834000

4.2. Correlation Analysis

Correlation analysis is used to depict the strength and direction of the linear relationship between two research variables. The value of Pearson correlation coefficients can only be between -1 and +1, where the sign indicates whether there is a positive or negative correlation, and the magnitude of the absolute value indicates the strength of the relationship. The results of the correlation between the research variables are displayed in Table 3.

Table 3.
Correlations between Variables.

	1	**2**	**3**	**4**	**5**
1. Log Market-to-book Ratio	-	-0.075**	0.019	0.107**	-0.003
2. P. of Insiders		-	-0.150**	-0.011	-0.220**
3. P. of Business Experts			-	0.048*	0.112**
4. Capital Structure				-	0.018
5. Firm Size					-

Note: **. Correlation is significant at the 0.01 level (2-tailed).
*. Correlation is significant at the 0.05 level (2-tailed).

From the table, the Pearson correlation coefficient between the log market-to-book ratio and the proportion of insiders on the board is -0.075, indicating a negative relationship between them. According to the effect size introduced by Cohen

[54], a correlation coefficient of 0.075 represents a weak relationship between these two variables. Additionally, the log market-to-book ratio also records a negative correlation with firm size, with a value of -0.003. However, a positive weak correlation is observed between the log market-to-book ratio and the proportion of business experts on the board, with values of 0.019 and 0.107, respectively.

Based on the correlation analysis, the proportion of insiders on the board of directors is negatively correlated with all variables, which are log market-to-book ratio (-0.075), the proportion of business experts on the board (-0.150), firm size (-0.220), and capital structure (-0.220). For the proportion of business experts on the board, it is positively correlated with log market-to-book ratio (0.019), capital structure (0.048), and firm size (0.112) at significance levels of 0.01 and 0.05; yet, it is negatively correlated with the proportion of insiders on the board of directors (-0.150).

The control variable, capital structure, has a positive correlation with the log market-to-book ratio, the proportion of business experts on the board, and the firm size at significance levels of 0.01 and 0.05, respectively, while it has a negative correlation with the proportion of insiders on the board. Lastly, firm size is negatively correlated with the log market-to-book ratio and the proportion of insiders on the board, while it is positively correlated with the proportion of business experts on the board and the capital structure.

4.3. Regression Analysis

Regression analysis is used to explore the relationship between one continuous dependent variable and a number of independent variables. In the study, multiple regressions were performed to examine the impact of the proportion of insiders and business experts on the board of directors on the financial performance of Malaysian listed manufacturing companies, measured by the log market-to-book ratio.

Tolerance is an indicator of the degree of variability of a specified independent variable that is not explained by the other independent variables in the model, whereas the VIF (Variance Inflation Factor) value is its inverse. Both are used in multicollinearity tests, and the absence of multicollinearity is indicated when the Tolerance level is more than 0.1 or the VIF value is less than 10.

Table 4.
Collinearity Test.

Variables	Collinearity Statistics	
	Tolerance	**VIF**
Proportion of Insiders on the Board	0.936	1.069
Proportion of Business Experts on the Board	0.969	1.032
Capital Structure	0.997	1.003
Firm Size	0.945	1.058

Table 4 displays the report values of the collinearity test results. The tolerance output for all the variables – the proportion of insiders in the board, the proportion of business experts in the board, capital structure, and firm size – are 0.936, 0.969, 0.998, and 0.945, respectively. With each tolerance value above 0.1 and VIF values lower than 10, it indicates that all the independent variables are independent and do not explain or significantly relate to each other. Therefore, the multicollinearity assumption is not violated in this study.

Table 5.
Regression Analysis.

Model	Standard Beta, *β*	P-value
Log Market-to-book Ratio		0.000
P. of Insiders	-0.078	0.001
P. of Business Experts	0.004	0.857
Capital Structure	0.113	0.000
Firm Size	-0.024	0.329

Note: a. Dependent Variable: LogMtB.

The regression model for the firm performance:

$$LogMtB = \beta_0 + \beta_1 PoI + \beta_2 PoBE + \beta_3 CapStruc + \beta_4 FSize + \mathcal{E}$$

Table 5 shows the coefficient output of the regression analysis. As shown, the proportion of insiders in the board has a beta value of -0.078, the proportion of business experts in the board ($\beta = 0.004$), capital structure ($\beta = 0.113$), and firm size ($\beta = -0.024$), respectively. Referring to the beta value, the capital structure has the largest beta coefficient ($\beta = 0.113$), which indicates it makes the strongest contribution to firm performance (market-to-book ratio). By ignoring the negative sign (-), the proportion of insiders in the board of directors makes the second-largest contribution to firm performance. The results show the statistical significance of the proportion of insiders in the board of directors towards firm performance; therefore, the first hypothesis in this study is supported. The other variables, which are the proportion of business experts in the board and firm size, result in relatively small beta coefficients, indicating they make less contribution to firm performance. Since the proportion of business experts in the board of directors has a minimal relationship with firm performance, as indicated by the very tiny beta value ($\beta = 0.004$), the second hypothesis of this study is not supported.

The output value from the P-value column represents the significant contribution of independent variables to the dependent variable. On one hand, the variables of proportion of insiders in the board of directors and capital structure have very low P-values of 0.001 and 0.000, respectively, which indicate that both of them contribute significantly to firm performance (market-to-book ratio). On the other hand, the variables of the proportion of business experts in the board of directors and firm size have P-values of 0.0857 and 0.329, respectively, indicating that they do not make significant contributions to firm performance.

Table 6.
ANOVA Test.

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	2.521	4	0.630	8.415	0.000[b]
	Residual	131.318	1753	0.075		
	Total	133.839	1757			

Note: a. Dependent Variable: LogMtB
b. Predictors: (Constant), FSize, CapStruc, PoBE, PoI.

Table 6 shows the result of the ANOVA test. The Analysis of Variance (ANOVA) test is used to assess the statistical significance of the study and determine whether to reject the null hypothesis or accept the alternative hypothesis. As shown in the table above, the model of this study reaches statistical significance since the significance value is 0.000 (lower than 0.05).

5. Discussion and Conclusion

The results of the hypothesis testing are disclosed in Table 7. According to the output of the regression analysis, hypothesis 1 in this study is supported by the findings, whereas hypothesis 2 is not supported at the significance level of $P < 0.05$.

Table 7.
Conclusion of Hypotheses.

Hypothesis 1:	The proportion of insiders on the board of directors is significantly associated with corporate financial performance.	Supported
Hypothesis 2:	The proportion of business experts on the board of directors is significantly associated with corporate financial performance.	Not Supported

As hypothesis 1 has been supported, the proportion of insiders on the board of directors has a significant association with corporate performance. Based on empirical studies, there are three different views regarding the relationship between the proportion of insiders and firm performance. Some researchers argue that they are not significantly related [44, 45]. Apart from that, there are some findings of studies saying that the insiders will positively affect the financial performance [42, 43, 46, 55] whilst some agree with the opposite one that the insiders will bring negative impacts to the firm's financial performance [47, 48]. After all, the result of this study reveals that the proportion of insiders on the board will negatively impact the company's financial performance. It indicates that when the proportion of insiders in a firm's board is higher, the financial performance of the firm will be less favorable. The reason can be that an increasing number of insiders on the board of directors further impairs board independence. When there are more insiders on a board, the risk of their not making independent decisions and taking actions in self-interest is relatively higher.

In addition, the rejection of hypothesis 2 demonstrates that the proportion of business experts on the board of directors is not associated with the firm's financial performance. The proportion of business experts may generate some effects on the firm's performance, but they are not significant enough to be mentioned. As decision experts in organizational environments who have gained general expertise to authorize and monitor decisions from other firms, business experts do not necessarily become an advantage to the firm. Of course, they are not yielding disadvantages to the firm as well. As is well known, each firm has an independent business environment where it will face different challenges and problems; thus, special strategies and decisions are required to deal with them. This explains why the decision or solution that is appropriate in other firms may not be favorable to apply in a particular firm. Therefore, the proportion of directors who have an active managerial affiliation with other organizations has no significant relationship with board effectiveness, as well as firm performance.

The result of this study clarifies that there is an association between the proportion of insiders on the board of directors and firm performance, yet the relationship is negative. Therefore, to boost firm performance, shareholders should appoint fewer insiders as their agents on the board. By controlling the number of insiders, the degree of independence in the board of directors can likely be safeguarded, which will help in achieving better firm performance. Since insiders can dedicate specific important functions to the firm, shareholders should not cease engaging any of them on the board; rather, having fewer insiders is more encouraged.

The study also denotes that there is no significant association between the proportion of business experts on the board of directors and firm performance. Business experts are being appointed as directors on boards because they are expected to play significant and specific roles that will benefit the boards and firms. However, the results of the study indicate that these expectations are unrealized. Therefore, the appointment of business experts to boards as directors is not truly necessary. Even though they do not bring positive impacts and have no association with firm performance, business experts

still perform some irreplaceable functions on the boards. In other words, business experts promote their functions in areas other than firm's financial performance. That is why, similar to insiders, shareholders should not cease engaging any of them on boards; rather, having fewer of them is more encouraged.

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