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**RELATED PARTY TRANSACTIONS, INDEPENDENT
DIRECTORS AND FIRM PERFORMANCE:
MALAYSIAN EVIDENCE**



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**DOCTOR OF PHILOSOPHY
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**RELATED PARTY TRANSACTIONS, INDEPENDENT DIRECTORS AND
FIRM PERFORMANCE: MALAYSIAN EVIDENCE**



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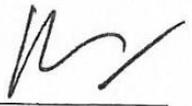
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ABSTRACT

Related party transactions (RPTs) have been identified as the most common tool used by corporate insiders to expropriate firm's resources, particularly in companies with weak governance mechanisms. In order to mitigate the problem, theorist argued that independent directors (INEDs), who are not beholden to the management, are better suited in protecting minority shareholders' interests. Therefore, this study aims to examine the effect of RPTs on firm performance and to determine whether this effect is moderated by the proportion of INEDs and their human capital (HC) and social capital (SC). Firm performance is measured by return on assets (ROA), while RPTs are measured based on total RPTs and types of related parties. INEDs' HC are captured by INEDs' functional knowledge in accounting and finance and INEDs' firm-specific knowledge, while INEDs' SC is proxied by INEDs' external networking. Using proportionate stratified random sampling, 300 non-financial firms listed on Bursa Malaysia in the year 2013 are randomly selected. The results reveal that in general, RPTs have a positive effect on firm performance and this effect varies according to the types of parties involved in RPTs. The findings support the efficient transactions hypothesis that RPTs can be used for sound business reasons. The proportion of INEDs and all constructs for INEDs' HC and SC are revealed to not have any moderating effect on the relationship between RPTs and firm performance. Therefore, the results are not in line with the predictions from the agency, resource dependence, human capital, and social capital theories. The unexpected findings raise questions of whether INEDs in Malaysia are truly independent or just fulfilling the Malaysian Code on Corporate Governance and Bursa Malaysia Listing Requirements. Hence, any efforts undertaken by the Malaysian regulators to strengthen the roles of INEDs should focus on the substance rather than the form.

Keywords: human capital, independent directors, related party transactions, resource dependence, social capital

ABSTRAK

Urusniaga pihak berkaitan (UPB) telah dikenalpasti sebagai alat yang paling biasa digunakan oleh pihak dalaman korporat untuk menguasai sumber firma, terutamanya bagi syarikat yang mempunyai mekanisme tadbir urus yang lemah. Bagi menangani masalah tersebut, ahli teori berpendapat bahawa pengarah bebas (PB), yang tidak mempunyai hubungan dengan pihak pengurusan, lebih sesuai untuk melindungi kepentingan pemegang saham minoriti. Oleh itu, kajian ini bertujuan untuk mengkaji kesan UPB ke atas prestasi firma dan untuk menentukan sama ada kesan tersebut disederhanakan oleh perkadaran PB serta modal insan (MI) dan modal sosial (MS) mereka. Prestasi firma diukur melalui Pulangan atas Aset (ROA), dan UPB pula diukur berdasarkan jumlah UPB dan jenis-jenis pihak berkaitan. MI PB diwakili oleh pengetahuan fungsian dalam perakaunan dan kewangan serta pengetahuan khusus berkaitan firma, manakala MS PB pula diwakili oleh hubungan luar PB. Dengan menggunakan persampelan rawak strata berkadaran, sejumlah 300 buah syarikat bukan kewangan yang tersenarai di Bursa Malaysia dalam tahun 2013 telah dipilih secara rawak. Hasil kajian mendedahkan bahawa secara umumnya, UPB mempunyai kesan positif terhadap prestasi firma dan kesan ini berbeza bergantung kepada jenis-jenis pihak yang terlibat dalam UPB. Penemuan kajian ini menyokong hipotesis urusniaga efisien bahawa UPB boleh digunakan untuk alasan perniagaan yang baik. Perkadaran PB serta semua konstruk MI dan MS PB didapati tidak mempunyai kesan penyederhanaan ke atas hubungan di antara UPB dan prestasi firma. Oleh yang demikian, keputusan kajian ini tidak selari dengan jangkaan teori agensi, pergantungan sumber, modal insan dan modal sosial. Penemuan yang tidak dijangka ini menimbulkan persoalan sama ada PB di Malaysia benar-benar bebas atau hanya memenuhi Kod Tadbir Urus Korporat Malaysia dan Keperluan Penyenaraian Bursa Malaysia. Justeru, sebarang usaha yang dilakukan oleh badan kawal selia di Malaysia untuk mengukuhkan peranan PB perlulah memberi tumpuan kepada isi pokok dan bukannya bentuk.

Keywords: modal insan, pengarah bebas, urusniaga pihak berkaitan, pergantungan sumber, modal sosial

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LIST OF ABBREVIATIONS

BMLR	Bursa Malaysia Listing Requirements
CAR	Cumulative Abnormal Return
CEO	Chief Executive Officer
CFA	Chartered Financial Analyst
CGB	Corporate Governance Blueprint
CGG	Corporate Governance Guide
GAAP	Generally Accepted Accounting Principles
HC	Human Capital
IFRS	International Financial Reporting Standards
INEDs	Independent Directors
IPO	Initial Public Offering
MCCG	Malaysian Code on Corporate Governance
MFRS	Malaysian Financial Reporting Standards
MIA	Malaysian Institute of Accountants
MSWG	Minority Shareholder Watchdog Group
OECD	Organization for Economic Co-operation and Development
OLS	Ordinary Least Square
PLC	Public-listed Company
ROA	Return on Assets
RPTs	Related Party Transactions
SC	Social Capital
SME	Small and Medium Enterprise
SOX	Sarbanes-Oxley Act
UAE	The United Arab Emirates
UK	The United Kingdom
US	The United State of America

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

Related party transactions¹ (RPTs) refer to the transfer of resources, services, or obligations between related parties, regardless of whether a price is charged, while a related party is a person or entity that is related to the entity that is preparing its financial statements (Malaysian Financial Reporting Standards [MFRS] 124, 2011). These transactions are a common business feature as firms frequently carry out their operations through subsidiaries, associates, and joint ventures. Thus, it is the companies' responsibility to ensure that RPTs are conflict-free and are conducted at arm's length.

However, many abusive cases of RPTs in Asia, including Transmile Group Berhad (Malaysia), Satyam Computers Ltd (India), CNOOC Ltd (Hong Kong), Shinsegae Group (the Philippines), Asia Pulp and Paper (Indonesia), and others, demonstrate how RPTs ultimately benefited the company insiders (i.e. top management or controlling shareholders). Abusive RPTs refer to the situation where a controlling party² of a firm enters into a transaction that is detrimental to non-controlling shareholders³ (Organization for Economic Co-operation and Development [OECD], 2009).

¹ Some jurisdictions use different terms to refer to RPT. For instance, Australia uses the term "transaction with persons in position of influence", Hong Kong uses the term "connected transaction", and Singapore uses the term "interested person transaction".

² The term "controlling party" is used interchangeably with "controlling owner" and "controlling shareholder".

³ The term "non-controlling shareholders" is used interchangeably with "minority shareholders".

Abusive RPTs have received global concern after the 1997/1998 Asian financial crisis and the widespread accounting scandals involving companies in both developed and developing countries. The absence of effective governance and monitoring mechanisms exacerbates the problem of abusive RPTs. Empirical evidence showed that RPTs are the most common tool used by controlling parties to expropriate firm's resources, particularly in companies that have poor corporate governance structure (Cheung, Jing, Lu, Rau, & Stouraitis, 2009; Dahya, Dimitrov, & McConnell, 2008; Gordon, Henry, & Palia, 2004; Munir, Mohd Salleh, Jaafar, & Yatim, 2013).

For example, in the accounting scandal involving Transmile Group Berhad (Transmile), related party sales transactions had been used to window dress its financial performance. Consequently, its revenue was overstated by a total of RM622 million for the years starting from 2004 to 2006. After the exposure of this fraud issue, Transmile's share price dropped from RM14.40 to RM4.64 on 3 January 2007, then below RM0.50 since March 2010. Former Transmile's directors were compounded RM1.9 million and former independent directors (INEDs) were jailed for one year and fined RM300,000 due to misleading financial statements. The scandals eventually caused Transmile to be delisted from Bursa Malaysia on 24 May 2011 (Abdul Hamid, Shafie, Othman, Wan Hussin, & Fadzil, 2013; Omar, Said, & Johari, 2016).

The potential problem with RPTs is that their economic substance may differ from their legal form. Some RPTs might not be undertaken at market prices or with no exchange consideration, but rather are influenced by the relationships between the parties involved in the transaction. For instance, controlling parties might sell (purchase) assets or goods at below (above) market value, provide overpriced services,

or receive loans on advantageous terms. The negative consequences of illegitimate or abusive RPTs had been documented in both the literature on RPTs and corporate governance. They had been proven to reduce earnings quality (Aharony, Wang, & Yuan, 2010), reduce firm value (Gordon et al., 2004), and lead to the loss of business opportunities for the listed companies (OECD, 2009). At their worst, RPTs played a vital role in contributing to corporate collapses, which in turn had erased billions of dollars of shareholder values and eroded investors' confidence in the capital markets (CFA Institute, 2009).

Companies in Asian region, including Malaysia, are more prone to engage in RPTs because of their concentrated ownership structure (Abdul Wahab, Haron, Lok, & Yahya, 2011; CFA Institute, 2009; Cheung et al., 2009). A large number of organisations are either run by the families or run by the state. In family-controlled firms, nearly all of the top management positions are occupied by members of the family, while in state-controlled firms, the positions are dominated by political appointees (CFA Institute, 2009). By holding these positions, the controlling parties have the power to exert significant influence and control over corporate affairs, together with a decision to initiate RPTs.

Moreover, it is not uncommon for many Asian firms to belong to business groups and to be controlled by single individual or wealthy families through the pyramidal structure. In such pyramidal business groups, the ultimate controlling shareholders can exert control over the firms of the group members via a chain of ownership relations. According to Bebchuk, Reiner, and Triantia (2000) and Riyanto and Toolsema (2008), this pyramidal structure enables the ultimate shareholder to maintain control of the

lower-level firms with small cash flow rights, hence creating a separation between cash flow and control rights. Therefore, with this highly concentrated ownership landscape and the existence of a separation between ownership and control, controlling parties have greater incentive and ability to divert firm resources for their private benefit instead of sharing them with the other shareholders.

Although RPTs may have a potential to be abused, such transactions are still allowed under the law of many jurisdictions. It is evident that not all RPTs negatively affect the company as they might be conducted for the legitimate business purpose, which eventually can increase the shareholders' value (Cheung, Rau, & Stouraitis, 2006; 2009; Friedman, Johnson, & Mitton, 2003). RPTs are also subject to specific rules and regulations that can be found in company law, accounting standards, listing requirements, and codes of corporate governance. Furthermore, companies involved in RPTs are required to develop an effective system of checks and balances to ensure that these dealings are conducted within the limits as prescribed by the relevant laws, rules, and regulations (CFA institute, 2009). In many cases, RPTs are perceived as beneficial, unavoidable, and recurring in ongoing operations (OECD, 2009).

If firms are prohibited from engaging in RPTs, they may be unable to maximise shareholders value. Djankov, La Porta, Lopez-De-Silanes, and Shleifer (2008) explained that no country completely prohibits a company from entering into RPTs; this supports the view that RPTs can be value enhancing. There is evidence that RPTs can create value to the firms (Peng, Wei, & Yang, 2011) provided there are regulations and laws available to monitor such transactions (Ge, Drury, Fortin, Liu, & Tsang, 2010). Under certain circumstances, RPTs can also be used to prop up distressed firms

and to rescue the firms from bankruptcy (Cheung et al., 2009; Friedman et al., 2003; Riyanto & Toolsema, 2008). In addition, companies might engage in RPTs to fulfil their underlying needs by creating strategic partnerships, enhancing risk sharing, and facilitating contracts with their related parties (Kohlbeck & Mayhew, 2010).

The issue of whether RPTs are beneficial or harmful to the minority shareholders is still highly debated at both the international and national levels. An area of concern regarding this issue is a mechanism that can restrain the controlling shareholders from engaging in transactions that might put the minority investors at risk (La Porta, Lopez-Silanes, Shleifer, & Vishny, 2000). Therefore, this raises a demand for adequate shareholder protection against opportunistic behaviour of the controlling shareholders.

Kohlbeck and Mayhew (2010) asserted that the ability of insiders to behave opportunistically is higher when the monitoring mechanisms to lessen or to avoid the frequency of such behaviour are weak or do not exist. Without an effective monitoring mechanism, the insiders may use their power to expropriate the minority shareholders by engaging in RPTs that can serve their own interest. Since RPTs are diverse and often complex (Gordon et al., 2004), curbing and monitoring of these transactions represent a big challenge for all countries around the world. Even though some forms of mechanisms exist to monitor RPTs in many jurisdictions, abusive RPTs are still pervasive. Consequently, effective curbing and monitoring of RPTs has come to the forefront in the corporate governance reform among Asian countries (OECD, 2009). It was argued that firms with higher quality of corporate governance increase the cost of diversion to the controlling parties and hence, limit their abilities to be involved in the expropriation activities (Dahya et al., 2008).

After the 1997/1998 Asian financial crisis and a series of accounting scandals in the past two decades, great reliance has been placed on INEDs as a means of monitoring abusive RPTs. For example, the United States (US) Congress reacted to these scandals by enacting the Sarbanes-Oxley Act (SOX) in 2002 to strengthen the independence of the directors of US publicly traded companies. The concept of INEDs was first introduced voluntarily in the US in the 1950s before it was enacted by law (Gordon, 2007). It was then transplanted to other jurisdictions, including Asia (Varottil, 2010). In Malaysia, the structure of corporate governance, company law, and accounting standards have been reformed and amended for numerous reasons including to curb abusive RPTs and to strengthen the role of INEDs. Chapter Two will discuss further details regarding the rules and regulations relating to RPTs and INEDs.

In a firm, the board of directors is the focal point of corporate governance. While the management is responsible to run the firm, it is the directors' duty to govern the firm by overseeing the management and representing the interests of the firm's shareholders. However, in concentrated ownership structure like Malaysia, it is common for family members or bureaucrats to dominate the board of directors and senior managerial positions. When family members or bureaucrats are present on the corporate board, they are more likely to make decisions that favour the controlling shareholders. Therefore, they may not fairly represent the best interest of minority shareholders.

In order to overcome the problem, an independent party who is not beholden to the management and has no relationship with the firm is required to exercise a more effective monitoring role. For that reason, INEDs, being independent of insider

influence, appear to be an appropriate institution to better protect the shareholders from insiders' opportunism. It is expected that their presence in the corporate boardroom will ensure that no group or individual party can dominate the decision-making processes. As argued by Fama and Jensen (1983), the presence of INEDs on the board would result in better monitoring of the boards and thus, limit managerial opportunistic behaviours.

With respect to RPTs, board approval is the primary method in protecting the minority shareholders (OECD, 2012). In the board approval process, INEDs play a crucial role in reviewing and approving the terms and conditions of RPTs to prevent abuse (OECD, 2012). As a guardian of the minority shareholders, there is an expectation that INEDs scrutinise the proposed RPTs undertaken by a firm in an effort to ensure that the transactions are fair, reasonable, and are in the best interest of all shareholders. Effective monitoring by INEDs could raise the cost of diversion to the controlling shareholders and thereby, reduce the controlling shareholders' ability to channel resources out of the company (Dahya et al., 2008). Indeed, a body of rules, regulations, and guidelines exists in more advanced jurisdictions, which lay down the duties and responsibilities of INEDs in overseeing abusive RPTs.

The importance of INEDs in monitoring RPTs is recognised by the OECD. The OECD (2004) recommended that INEDs should play a significant role, including "monitoring and managing potential conflicts of interest among the management, board members, and shareholders, including the misuse of corporate assets and abuse in RPTs" (p. 24). The OECD subsequently released its Guide on Fighting Abusive RPTs in September 2009. The guide addresses the role of INEDs and recommends that they "should play

a central role in monitoring RPTs, such as designing board approval procedures, conducting investigations, and having the possibility for obtaining advice from independent experts” (OECD, 2009, p. 8).

In discharging their duties and responsibilities, INEDs must be competent in the sense that they must possess sufficient skills and knowledge (Kor & Sundaramurthy, 2009). Individually, INEDs may have inadequate skills and knowledge, but when working together as a group, they can collectively bring multiple perspectives into a firm and pool their “human capital and social capital” (HC and SC) in the forms of skills, experience, knowledge, and networking to provide high-quality outcomes (Kor & Sundaramurthy, 2009). Many recent scholars argued that INEDs’ HC and SC shapes the ability of INEDs to perform their governing and advising functions (Hillman & Dalziel, 2003).

The benefits associated with directors’ HC and SC had been acknowledged by a number of scholars. For example, boards with high HC and SC are argued to provide (i) better access to larger pool of high-quality information (Carpenter & Westphal, 2001; Tian, Haleblan, & Rajagopalan, 2011); (ii) better decision making such as in the chief executive officer’s (CEO) selection process (Tian et al., 2011) and acquisition decision (Kroll, Walters, & Wright, 2008); and (iii) better firm’s outcomes such as higher environmental performance (De Villiers, Naiker, & Staden, 2011) and higher rate of sales growth (Kor & Sundaramurthy, 2009). This implies that appointing directors (including INEDs) with relevant skills, expertise, and knowledge is essential for a firm because they can bring valuable resources that can enhance and sustain the firm performance.

Based on the above discussion, this research aims to examine RPTs in the Malaysian setting. Specifically, this research investigates the effect of RPTs on firm performance and the moderating effects of the proportion of INEDs and their HC and SC on the relationship between RPTs and firm performance. Malaysia offers an interesting setting to study these issues because similar to other emerging markets, RPTs are a common business deal among Malaysian companies. This situation can be associated with the economy of Malaysia that is characterised by a relationship-based system (Abdul Wahab et al., 2011). In addition, the ownership structure of Malaysian companies is highly concentrated where families and the government own significant equity ownership in many listed companies. For example, Claessens, Djankov, Fan, and Lang (2002) found that in Malaysia, the top 10 families control approximately 25 % of the total market capitalisation. Therefore, it is not surprising that the economic transactions of many Malaysian companies tend to be based on connections.

Apart from that, a substantial number of Malaysian listed companies belong to large business groups where members are bound together by formal and/or informal ties. Such a structure may result in the widespread practice of RPTs. Weak enforcement of regulations and low protection of shareholders in Malaysia also create incentives for the controlling shareholders to expropriate the wealth of the minority shareholders via RPTs (Munir et al., 2013). Therefore, it is essential to explore the effect of RPTs in the Malaysian setting.

Additionally, the 1997/1998 Asian financial crisis brought to light the importance of INEDs as a governance mechanism to safeguard the interest of minority shareholders. The structure of corporate governance, company law, and accounting standards in

Malaysia have been reformed and amended for several reasons including to strengthen the role of INEDs. The Malaysian Code of Corporate Governance (MCCG) and Bursa Malaysia, for example, require that the board members and board committees to consist of INEDs. These INEDs should be persons of calibre and credibility, in addition to having the necessary skills and experience. This is to ensure that they can safeguard the interest of the minority shareholders. Thus, it is vital to examine the role of INEDs in the Malaysian setting to gain further insight on whether the reforms have resulted in greater effectiveness of INEDs.

1.2 Problem Statement

The 1997/1998 Asian financial crisis and the widespread accounting scandals involving many well-known companies around the world raise concerns, among others, on two important and related issues: expropriation of minority shareholders and poor corporate governance practices. The expropriation of minority shareholders is defined as the process by which the controlling shareholders use their powers to divert corporate resources at the expense of minority shareholders (Claessens, Djankov, & Lang, 2000). This problem is particularly happen in countries with concentrated ownership structure like Malaysia (Abdul Wahab et al., 2011; CFA Institute, 2009; Munir et al., 2013). A study by Abdullah (2006) reported that approximately 36% of Malaysian firms' shares are held by single largest shareholder. According to Tam and Tan (2007), the average concentration of the five largest shareholder in the top 150 Malaysian firms is 54.58%. This substantial ownership allows controlling shareholders to divert firm resources from minority shareholders through self-dealing transactions (Djankov et al., 2008). The issue is further exacerbated by lack of strong legal environment and shareholder activism in Malaysia (Munir et al., 2013).

The extant literature revealed that RPTs were the major instrument used by the controlling shareholders to expropriate minority shareholders (Cheung et al. 2009; Dahya et al. 2008; Munir et al., 2013). Empirical evidence by Haji Abdullah and Wan Hussin (2015), Hasnan, Daie and Hussain (2016) and Munir et al. (2013) documented that many companies in Malaysia use RPTs as a source of earnings management. Among the popular examples of abusive use of RPTs in Malaysia are found in Genting Malaysia Berhad, Tai Kwong Yokohama Berhad, Tradewinds Malaysia Berhad and Transmile Berhad (Abdul Wahab et al., 2011). In all cases, RPTs benefits the top management and controlling shareholders the most. These abusive cases resulted in decreasing firm's value and a massive loss of confidence by investors in the Malaysian capital market (Abdul Wahab et al., 2011, Munir et al., 2013). In addition, a study conducted by the Minority Shareholder Watchdog Group (MSWG) in 2013 revealed that among the 862 Malaysian public-listed companies (PLCs), only 34 per cent or 294 companies disclosed that RPTs were fair and conducted at arm's length (MSWG, 2013). However, the percentage was dropped to 24 per cent in 2016 (MSWG, 2016). This trend raises concern whether minority shareholders in Malaysia are properly protected from abusive RPTs.

Since the 1997/1998 Asian Financial Crisis, many reforms to the law and regulation systems have been instilled in Malaysia in order to curb abusive RPTs. Among them are Bursa Malaysia Listing Requirements (BMLR), Malaysia Code of Corporate Governance (MCCG), Malaysian Financial Reporting Standards (MFRS) and Malaysian Companies Act 2016. Part E of Chapter 10 of the BMLR, lay down requirements that need to be complied with respect of RPTs entered by a PLC or its subsidiaries. The MCCG provides a set of principles and best practices for companies

on corporate governance. MFRS 124 *Related Party Disclosures*, contains guidelines on disclosure of RPTs. Sections 221, 222, 224 and 225 of the Companies Act 2016 provide detailed provisions relating to related party dealings. These rules and regulations are explained in detail in Chapter 2. Considering to a number of reforms undertaken by the Malaysian government to combat abusive RPTs, it is therefore important to examine the current practices of RPTs in Malaysia and their effect on firm performance.

Previous studies consistently provide evidence that companies with poor corporate governance practices tend to engage in numerous RPTs (Gordon et al., 2004; Kohlbeck & Mayhew, 2010). Thus, without proper monitoring mechanism in place, it provides an opportunity for the managers and controlling shareholders to divert corporate resources at the least cost to them. Jensen and Meckling (1976) and Kohlbeck and Mayhew (2010) suggested that effective monitoring mechanisms can play a vital role in disciplining RPTs and hence, reduce conflict of interest associated with the dealings. Under the efficient transaction perspective, a firm can avoid the appearance of conflict of interest by increasing the monitoring of RPTs. Since RPTs mainly involve related parties within the top management and controlling shareholders, therefore, it is a question as to what kind of corporate governance standing that can monitor firms' RPTs effectively.

Since the financial crisis of 1997/1998, restraining controlling shareholders from extracting private benefits has been a principal focus in the corporate governance reform in many countries. INEDs, who have no pecuniary relationship with the firm or related persons, has emerged as one of the centrepieces of the corporate governance

reform. Their independence means that they have a vital role to play in monitoring RPTs (Rachagan, 2011). They are expected to limit the potential opportunism of the insiders in a principal-agent relationship. In particular, INEDs have a responsibility to scrutinise RPTs to ensure that the transactions are fair and reasonable, and not to the disadvantage of the minority shareholders. These roles are performed through their engagement in audit committees, RPTs committees, and/or remuneration committees. Accordingly, regulators in many jurisdictions believe that INEDs are the ideal personnel to perform the board's monitoring tasks (Sharpe, 2011).

Due to the essential role played by INEDs as corporate monitors, publicly traded corporations worldwide have been forced to increase the representation of INEDs on their board of directors. Currently, almost all jurisdictions have published guidelines proposing minimum representation of INEDs on corporate boards. For example, the BMLR requires at least two (2) or one third (1/3) of board members in Malaysian PLCs, whichever is higher, are INEDs.

The premise underlying greater participation of INEDs is that outsider-dominated boards (i.e. boards dominated by INEDs) would lead to enhanced corporate governance, which in turn would improve investor protection than boards dominated by internal directors. Nevertheless, there is no solid empirical evidence to support that expectation. Some studies documented that a higher percentage of INEDs lessen the negative impact of RPTs on firm's outcomes (e.g. Cheung et al., 2009; Dahya et al., 2008; Gallery, Gallery, & Supranowicz, 2008; Khosa, 2017), while others failed to provide such evidence (e.g. Ararat, Orbay & Yurtoglu, 2010; Cheung et al., 2006).

One possible explanation for the inconclusive results may stem from previous studies treating INEDs as homogenous and therefore, overlooking their heterogeneous ability (Masulis, Ruzzierb, Xiao, & Zhao, 2012; Tian et al., 2011). As argued by Hillman and Dalziel (2003), while INEDs have the incentives to monitor managers and controlling shareholders, those with higher level of HC and SC in the forms of knowledge, experience, and networking, may perform their roles more effectively (Hillman & Dalziel, 2003; Tian et al., 2011). HC refers to the resources such as knowledge and experience that are embedded within individuals (Becker, 1962), whereas SC refers to the actual and potential resources embedded within, available through, and derived from the network relationships possessed by an individual (Nahapiet & Ghoshal, 1998).

INEDs' HC can range from industry familiarity, experience as CEO, experience in finance or specific activities, and overall familiarity with the firm (Johnson, Schnatterly, & Hill, 2013). INEDs' SC comprises of ties to other firms, personal relationships and affiliations with firm managers, or social standing (Johnson et al., 2013). INEDs who are better equipped with HC and SC can exert greater influence on the board's decision making (Hillman & Dalziel, 2003). Hence, the emerging theoretical work on board capital argued that a gap may appear between what INEDs are expected to achieve and the ability in the forms of knowledge, experience, and networking that they possess (Chen, Chang, & Hsu, 2017; Khanna, Jones, & Boivie, 2013; Kor & Sundaramurthy, 2009; Tian et al., 2011).

The importance of INEDs' HC and SC is also recognised by the MCCG. For example, the MCCG 2017 recommends that for the board to be effective, it should include "the

right group of people, with an appropriate mix of skills, knowledge, experience, and independent elements that fit the company's objectives and strategic goals" (p. 22). INEDs are appointed because of the resources (i.e. HC and SC) that they can bring to the boardroom. Prior studies documented that HC and SC are vital criteria that will be considered in the process for appointing board members (Annuar, 2012).

The latest MCG 2017 also requires the board to annually review the effectiveness of individual directors, which include an evaluation of the HC and SC that they possess. In particular, the board should "assess the director's (i) will and ability to critically challenge and ask the right questions; (ii) character and integrity in dealing with potential conflict of interest situations; (iii) commitment to due diligence, integrity, and serve the company; and (iv) confidence to stand up for a point of view"(MCG, 2017, p. 29). The recommendations indicate the need of INEDs to maintain their high level of HC and SC so that they can perform their roles effectively.

Despite the importance of INEDs' HC and SC in shaping INEDs' monitoring and advice-giving roles (Hillman & Dalziel, 2003; Kim, 2007; Tian et al., 2011), little or no research has related such capital to RPTs and consequently, on firm performance. Drawing upon resource dependence, human capital, and social capital theories, the present study was conducted to bridge the knowledge gap that exists in prior literature by investigating whether INEDs' HC and SC moderate the relationship between RPTs and firm performance. This study argues that INEDs with higher level of HC and SC have more knowledge and sources of information that can help them in dealing with issues relating to RPTs, which in turn are expected to improve firm performance. This argument is in line with the findings in the organisational behaviour studies that outline

that knowledge and information are among the critical components of good decision making that can lead to effective team performance (Sharpe, 2011).

1.3 Research Questions

According to the issues discussed in the problem statements, the main question is whether the proportion of INEDs and their HC and SC moderate the relationship between RPTs and firm performance. More specifically, the research questions of this study are as follows:

- a) Do RPTs (based on total RPTs and types of related parties) have relationship with firm performance among Malaysian firms?
- b) Does the proportion of INEDs moderate the effect of RPTs (based on total RPTs and types of related parties) on firm performance?
- c) Does INEDs' human capital (HC) moderate the effect of RPTs (based on total RPTs and types of related parties) on firm performance?
- d) Does INEDs' social capital (SC) moderate the effect of RPTs (based on total RPTs and types of related parties) on firm performance?

1.4 Research Objectives

The main objectives of this study are to examine the effect of RPTs on firm performance and to investigate the moderating effect of INEDs on the relationship between RPTs and firm performance. The specific objectives of this study are as follows:

- (a) To examine the effect of RPTs (based on total RPTs and types of related parties) on firm performance.

- (b) To investigate the moderating effect of the proportion of INEDs on the relationship between RPTs (based on total RPTs and types of related parties) and firm performance.
- (c) To analyse the moderating effect of INEDs' human capital (HC) on the relationship between RPTs (based on total RPTs and types of related parties) and firm performance.
- (d) To analyse the moderating effect of INEDs' social capital (SC) on the relationship between RPTs (based on total RPTs and types of related parties) and firm performance.

1.5 Significance of Research

As discussed earlier, this study was motivated by concerns about the presence of RPTs in many high-profile accounting scandals in the Western countries (e.g. Enron, WorldCom, and Adelphia) as well as in Asian countries (e.g. Satyam and Transmile), and the role of INEDs in monitoring RPTs. Since then, many reforms to the laws, regulations, and guidelines have been taken by the Malaysian government to curb abusive RPTs and to enhance the role of INEDs. Thus, this study is timely and contributes significantly towards an understanding on the nature of RPTs and the roles of INEDs in the Malaysian context. Accordingly, the outcomes of this study are essential for the regulators and policy makers, body of knowledge, and related theories.

1.5.1 The Regulators and Policy Makers

Notably, this study covered the period of 2013. Since the year 2007 until 2012, a number of reforms on RPTs had been implemented by the Malaysian government and regulatory bodies to increase transparency on disclosures of RPTs and to strengthen

investor protection against abusive RPTs. For example, in 2007, the Companies Act 1965 was amended and some new clauses were added in effort to tighten rules pertaining to RPTs. Effective 2012, firms are required to apply MFRS 124 *Related Party Disclosure* (identical to FRS 124 [Revised]). The standard was revised in 2010 and several amendments relating to the definition of related parties and disclosure for government-related entities had been included.

INEDs are one of the most important corporate governance mechanisms that have received considerable attention. For example, the Corporate Governance Guide (CGG, 2009) highlighted the key role of INEDs, particularly in areas where the interests of the management, the company, and the shareholders diverge, like RPTs. Being independent from the influence of controlling shareholders, they are expected to balance and limit the strong power of the controlling shareholders and hence, mitigate risks arising from conflict of interest transactions. In order to fulfil their governance role effectively, the MCCG 2000 and the latest MCCG 2017 highlighted the need to appoint INEDs amongst the persons with calibre and credibility, and who have the necessary skills and experience.

From time to time, numerous initiatives have been put forward to further strengthen the role of INEDs. Among others, the MCCG and BMLR recommended that (i) INEDs should be financially literate and at least one should be a member of an accounting association or body; (ii) INEDs' tenure have to be limited to nine years; (iii) INEDs should not sit on the board of more than five other PLCs; and (iv) the boards are required to annually review the effectiveness of individual directors.

Therefore, this study allows the researcher to assess the implementation and effectiveness of the reforms and hence, provide input to the relevant parties of whether the current reforms produce the expected results. The findings from this study can be valuable in the sense that they can assist the regulatory bodies in planning for a better protection of investors, specifically in the area of RPTs. Moreover, agency theory has been used by the MCCG as the fundamental line of reasoning in many aspects of its recommendations, including enhancing the role of INEDs. Therefore, by examining INEDs' HC and SC, this study provides additional insight to the regulatory bodies on the effect of INEDs' skills, knowledge, experience, and networking on the board's effectiveness.

1.5.2 Literature

In Malaysia, the topic of RPTs is relatively less researched. Most of prior studies were carried out in developed countries and China. The findings from these studies may be different from developing economies like Malaysia due to differences in (i) corporate governance practice; (ii) ownership structure; (iii) legal, regulatory, and institutional environments; and (iv) historical and cultural factors (Munir et al., 2013; Rachagan, 2011). For example, companies in developing countries like Malaysia tend to have concentrated ownership. In this setting, the main agency conflict occurs between the controlling shareholders and the minority shareholders. Hence, the various agency problems may lead to different types of RPTs.

This research contributes to the literature on RPTs and corporate governance in several ways. First, this study complements and extends prior studies by providing additional empirical evidence on RPTs and their effect on firm performance. Second, most

studies conducted in Malaysia (e.g. Abdul Wahab et al., 2011; Hasnan et al., 2016; Munir et al., 2013) treat all RPTs as the same and thus, such transactions are assumed to negatively impact firm's outcomes.

Yet, in many cases, RPTs may make economic sense to the firms and the shareholders. Moreover, these studies ignored the types of related parties when measuring RPTs. Therefore, the findings from these studies failed to reflect the potential effect of the relationship on firm's outcomes. By categorising RPTs into transactions with related entities (i.e. transactions with subsidiaries, associates, and joint ventures) and transactions with related persons (i.e. transactions with directors; major shareholders; person connected with directors or major shareholders or director-related entities), the findings of this study can provide further understanding regarding the practices of RPTs in Malaysia, including the potential effect of each category of related party on firm performance.

Third, drawing upon the insights of resource dependence, human capital, and social capital theories, this study contributes to the debate over conventional wisdom that "the more independent a board is, the better". Apart from board's independence, this study introduces INEDs' HC and SC as an important dimension of INEDs. This dimension is necessary for a more complete understanding of how such capital shapes the ability of INEDs to monitor and offer advice related to RPT decisions and consequently, the effect of RPTs on firm performance. Specifically, this study examines whether INEDs' HC and SC moderate the relationship between RPTs and firm performance.

The inclusion of INEDs' HC and SC variables are consistent with the argument put forward by the proponents of board capital perspective that INEDs must have sufficient ability to carry out their roles effectively (Hillman & Dalziel, 2003; Tian et al., 2011). This ability refers to the board's capital, which consists of HC and SC that they bring into the firm (Hillman & Dalziel, 2003; Khanna et al., 2014; Kor & Sundaramurthy, 2009). As far as the researcher is aware, this study is the first to examine the moderating effects of INEDs' HC and SC on the RPTs-firm performance relationship. Therefore, the results will further enhance the understanding on the role of INEDs.

1.5.3 Theories

This study makes two contributions to the theories. Firstly, in concentrated ownership structure, the key agency conflict is between the controlling shareholders and the minority shareholders. The minority shareholders in such structure tend to be more vulnerable to expropriation by the controlling parties. The agency theory suggests that good corporate governance can effectively mitigate the degree of conflict between controlling shareholders and minority shareholders. Therefore, the results from this study can enhance the understanding of the relevance of agency theory in explaining the monitoring role of INEDs in alleviating the opportunistic behaviour of controlling shareholders.

Secondly, despite the importance of INEDs as corporate monitors, very few studies had investigated how INEDs' HC and SC contribute to their ability to perform monitoring and advising roles. Responding to calls in recent studies for future studies to incorporate the directors' HC and SC when examining board's effectiveness

(Carpenter & Westphal, 2001; Hillman & Dalziel, 2003; Khanna et al., 2014), this study will apply the resource dependence, human capital, and social capital theories. Thus, the results from this study will provide better understanding on the ability of INEDs to alleviate controlling shareholders' opportunism in the context of RPT activities.

1.6 Scope of the Study

As discussed above, this study examines the relationship between RPTs and firm performance and the moderating effects of the proportion of INEDs and their HC and SC on the RPTs-firm performance relationship. A sample of 300 non-financial firms listed on Bursa Malaysia in 2013 will be used in this study. All the finance related firms, bank, insurance, and unit trust will be excluded due to their unique characteristics, operated in different compliance and regulatory environment and their performance data are difficult to calculate and to compare with firms in other industries. This study uses secondary data, mainly collected from companies' annual reports, stock exchanges and companies' websites and DataStream.

1.7 Definition of Key Terms

This section briefly defines and explains some key terms that have been used throughout this thesis. These comprise:

1.7.1 Independent Directors (INEDs)

INED in this study refers to "a director who is independent of management and free from any business or other relationships which could interfere with the exercise of independent judgement or the ability to act in the best interests of the company"

(BMLR, 2018, p. 1). The detailed definition of an INED is set out in paragraph 1.01 of the BMLR. Any director that falls outside the Bursa's Malaysia definition of INED is excluded from this study.

1.7.2 The Proportion of INEDs

In this study, the proportion of INEDs is used as a proxy of board independence and measured as a total number of INEDs to the total number of directors (Abdul Wahab et al., 2011; Cheung et al., 2006; Hasnan et al., 2016; Khosa, 2017; Nekhili & Cherif, 2011).

1.7.3 INEDs' Human Capital and Social Capital

INEDs' HC refers to the resources such as knowledge, expertise and experience that are embedded within individuals (Becker, 1962; Hillman & Dalziel, 2003), whereas SC refers to the actual and potential resources embedded within, available through, and derived from the network relationships possessed by an individual (Nahapiet & Ghoshal, 1998). These capitals are multidimensional construct. This study concentrated only on three important constructs of INEDs' HC and SC namely INEDs' functional knowledge in accounting and finance, INEDs' firm-specific knowledge and INEDs' external networking.

The constructs are defined as follows:

- (a) INEDs' functional knowledge refers to knowledge in accounting and finance that INEDs developed from their previous employment experience in finance, accounting or professional certification in accounting or finance. It was calculated based on the total number of INEDs with financial expertise divided by the total

number of INEDs in the firm (Carcello & Neal 2003; Hoitash, Hoitash, & Bedard, 2009; Zhang, Zhou, & Zhou, 2007).

Consistent with other studies (e.g. Carcello & Neal 2003; Hoitash et al., 2009; Zhang et al., 2007), INEDs are considered to have accounting and financial knowledge if they have experience as: (a) a certified public accountant, auditor, principal, chief financial officer, controller, or chief accounting officer; or (b) a chief executive officer, president, or chairman of the board in a for profit corporation, or who has experience as the managing director, partner or principal in venture financing, investment banking, or money management.

(b) INEDs' firm-specific knowledge refers to detailed information about the firm and an intimate understanding of its operations and internal management issues (Forbes & Milliken, 1999). It was measured based on the total INEDs' tenure divided by the total number of INEDs in the firm (Fisher & Pollock, 2004; Hitt, Bierman, Shimizu, & Kochhar, 2001; Kor & Sundaramurthy, 2009). In this study, INEDs' tenure refers to the number of years that INEDs have served on a particular board.

(c) INEDs' external networking refers to the level of INEDs' external interconnectedness which includes actual or potential ties to external organizations and other contingencies (Hillman & Dalziel, 2003; Kim, 2007; Melkumov & Khoreva, 2015). It was measured based on the total number of INEDs' directorships at other firms divided by the total number of INEDs in the firm (Chen, 2013; Ferris, Jaganathan, & Pritchard et al., 2003; Kor & Sundaramurthy,

2009; Tian et al., 2011). This study considered only outside directorships in PLCs because not all companies provide information about the outside directorships in private companies (Kamardin, Abdul Latif, Taufil Mohd, & Che Adam, 2014).

1.7.4 Related Party Transactions (RPTs)

RPTs refer to “a transfer of resources, services or obligations between related parties, regardless of whether a price is charged” (MFRS 124, 2011, p. 847). These transactions are measured as the sum of the monetary values of RPTs disclosed in the 2013 annual reports for each listed firm in the sample, scaled by the total assets of the firm as at the fiscal year of 2013 (Abdul Wahab et al., 2011; Hasnan et al., 2016). A higher value of RPTs indicates that such transactions pose a greater conflict of interest (Abdul Wahab et al., 2011).

1.7.5 Related Parties

A related party refers to “a person or entity that is related to the entity that is preparing its financial statements” (MFRS 124, 2011, p. 846). In this study, types of related parties are classified into two major categories: (i) RPTs with related entities; and (ii) RPTs with related persons. Transactions with related entities include transactions involving subsidiaries, associates and joint ventures, while transactions with related persons include transactions involving directors; major shareholders; person connected with directors, major shareholders or director related entities.

1.7.6 Firm Performance

In this study, firm performance was measured based on Return on Asset (ROA). ROA was calculated by dividing net profit with total assets (Abdul Wahab et al., 2011; Chien

& Hsu, 2010; Haniffa & Hudaib, 2006; Klapper & Love, 2004; Munir et al., 2013). To ensure the robustness of the main findings, market-based performance (i.e. Tobin's Q) is employed as an alternate measure of firm performance. Tobin's Q was calculated as the ratio of the firm's market value divided by the total value of assets (Klapper & Love, 2004; Nekhili & Cherif, 2011).

1.8 Structure of the Thesis

This thesis is organised as follows:

Chapter 1 – Introduction: This chapter introduces the background of the study, problem statements, research questions, and research objectives. The significance of the study in terms of its contribution to the regulators and policy makers, literature, and theory is also highlighted. It then follows by briefly define some key terms that have been used throughout this thesis. Finally, a structure of the thesis is presented.

Chapter 2 – Literature Review: This chapter starts with a discussion on the legal and regulatory framework for RPTs and INEDs in Malaysia. It then follows by reviewing the literature on RPTs and INEDs that are relevant to this study.

Chapter 3 – Theoretical Framework and Hypotheses Development: This chapter develops the theoretical framework and research hypotheses. This chapter starts with a discussion on the theories used in this study, namely the agency theory, resource dependence theory, human capital theory, and social capital theory. The last part of this chapter highlights the development of hypotheses for this study. Three main hypotheses are developed: (i) the prediction of the relationship between RPTs and firm performance; (ii) the prediction on the moderating effect of the proportion of INEDs

on the RPTs-firm performance relationship; and (iii) the prediction on the moderating effects of INEDs' HC and SC on the RPTs-firm performance relationship.

Chapter 4 – Research Design: This chapter presents a detailed discussion of the research design of this study. The first section outlines the sample selection and sources of data. Consecutively, the variables' definition and measurements are explained. Finally, this chapter presents the regression model applied in this study.

Chapter 5 – Results and Discussion: This chapter describes the findings of the research based on the objectives of the study as outlined in Chapter 1. Descriptive statistics are first illustrated, followed by the empirical results for both direct and possible moderating effects of the proportion of INEDs and INEDs' HC and SC.

Chapter 6 – Conclusion and Recommendation: This chapter summarises and discusses the study's major contributions. Finally, this chapter presents the limitations of the present study and the recommendations for future studies.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter reviews the existing literature related to the current study. This chapter contains six sections. The first section discusses the scope of RPTs, which include the definition of RPTs and related parties and RPTs disclosures. The second section discusses RPTs from the perspective of conflict of interest and efficient transaction. The third section reviews previous studies related to RPTs. The fourth section deals with the scope of INEDs; it starts with a definition of INEDs and follows with the appointment process of INEDs in Malaysia, rules and guidelines relating to INEDs and their roles and responsibilities. The fifth section reviews previous studies related to INEDs and this section focuses on the proportion of INEDs and their HC and SC. Finally, the sixth section concludes the main themes outlined in this chapter.

2.2 Scope of Related Party Transactions

2.2.1 Definition of Related Party Transactions

In Malaysia, RPTs are considered as a normal feature of business and commerce. Most companies perform their business activities through subsidiaries, joint ventures and associates, for sound business reasons. Paragraph 9 of MFRS 124 *Related Party Disclosure*⁴ defines RPT as a transfer of resources, services or obligations between related parties, regardless of whether a price is charged. The examples of RPTs as prescribed in MFRS 124 include: (a) purchases or sales of goods; (b) purchases or

⁴ MFRS 124 *Related Party Disclosures*, which is equivalent to IAS 24 *Related Party Disclosures* was issued in November 2011.

sales of property and other assets; (c) rendering or receiving of services; (d) leases; (e) transfers of research and development; (f) transfers under licence agreements; (g) transfers under finance arrangements; (h) provision of guarantees or collateral; (i) commitments of doing something if a particular event occurs or does not occur in the future; and (j) settlement of liabilities on behalf of the entity or by the entity on behalf of that related party.

All Malaysian PLCs must also comply with the BMLR. Part E of Chapter 10 of the BMLR defines RPT as a transaction entered into by the PLC or its subsidiaries which involves the interest, direct or indirect, of a related party. While recurrent related party transaction refers to a related party transaction which is recurrent, of a revenue or trading nature, and which is necessary for day-to-day operations of a PLC or its subsidiaries.

The scope of RPTs is also covered by the new Companies Act 2016 (Act 777)⁵. For example, Sections 224 and 225 deal with loans to directors and persons connected with directors. According to these Sections, a company shall not make a loan to a director of the company or a related company or any person connected with a director of the company. These Sections also prohibit a company from entering into any guarantee or providing any security in connection with a loan made to such a director or

⁵ Starting from 31 January 2017, the Companies Act 2016 (Act 777) replaced the existing Companies Act 1965 as a whole. There are no significant changes relating to RPTs except for the changes in the numbering of the provisions pertaining to: (a) Disclosure of interest in contracts, proposed contract, property and offices (Section 221); (b) Interested director not to participate or vote (Section 222); (c) Loans to director (Section 224); and (d) Prohibition of loan to persons connected with directors (Section 225).

connected person by any other person. This is to avoid self-dealing by directors or connected person who may use the company's funds for their own benefits.

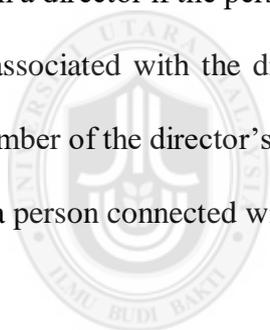
2.2.2 Definition of Related Party

According to MFRS 124 *Related Party Disclosure*, a related party refers to a person or entity that is related to the entity that is preparing its financial statements. The standard stresses that when determining whether a party is a related party, the substance of the relationship as well as the legal form should be taken into consideration. Referring to Paragraph 9 of MFRS 124, a related party can be:

- (a) A person or a close member of that person's family if that person:
 - (i) has control or joint control;
 - (ii) has significant influence over; or
 - (iii) is a member of the key management personnel of the reporting entity
- (b) An entity of any of the following conditions applies to:
 - (i) an entity and the reporting entity are members of the same group
 - (ii) one entity is an associate or joint venture of the other entity
 - (iii) both entities are joint ventures of the same third party
 - (iv) one entity is a joint venture of a third entity and the other entity is an associate of the third entity.
 - (v) the entity is a post-employment benefit plan for employees of the entity, or of any entity that is related to that entity.
 - (vi) the entity is controlled or jointly controlled by a person identified in (a).
 - (vii) a person identified in (a)(i) has significant influence over the entity or is a member of the key management personnel of the entity

(viii) the entity, or any member of a group of which it is a part, provides key management personnel services to the reporting entity or to the parent of the reporting entity.

A related party as described in Paragraph 9 of MFRS 124 is consistent with the main definition provided by the BMLR. As shown in Figure 2.1, the persons who are included in the definition of related party as per the BMLR are directors, major shareholders or persons connected with such directors or major shareholders. The definition of persons connected with directors is further elaborated in Section 197 of the Companies Act 2016. The Act states that a person shall be deemed to be connected with a director if the person is a member of the director's family, or a corporate which is associated with the director, or a trustee of a trust under which the director or a member of the director's family is beneficiary, or a partner of that director or a partner of a person connected with the director.



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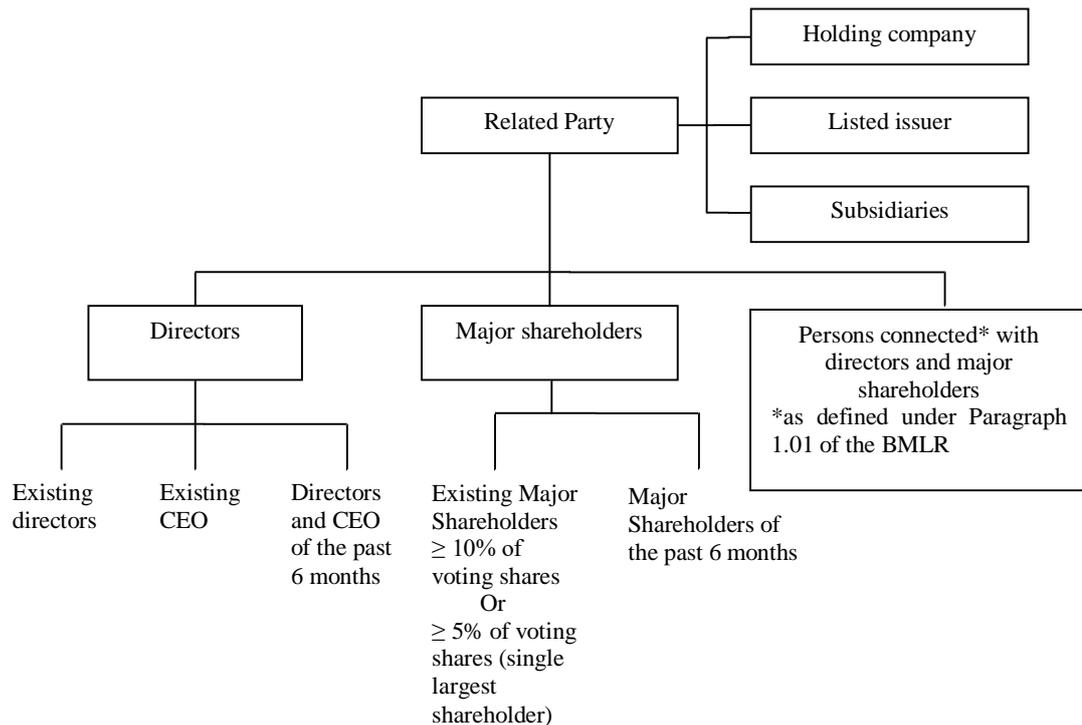


Figure 2.1
Related Party as defined under Chapter 10 of the BMLR
 Source: Corporate Governance Guide, 2009

2.2.3 Disclosure of Related Party Transactions

RPTs disclosures provide users of financial statements with the necessary information to value RPTs. Transparent and consistent disclosure of RPTs can help investors either to discipline opportunistic behavior of controlling shareholders and managers or to take precautions against it (Kohlbeck & Mayhew, 2010). It is evident that rules and regulation on RPTs disclosures are associated with better developed stock markets which indicate that RPTs disclosures help in alleviating the adverse effects of self-dealing activities (Djankov et al., 2008).

In Malaysia, the disclosure requirement with respect to RPTs is prescribed by MFRS 124 *Related Party Disclosure*, Part E of Chapter 10 of the BMLR and the Companies

Act 2016. MFRS 124 requires an entity to disclose related party relationships, transactions and outstanding balances, including commitments, in the entity's financial statements, which include at least:

- (a) the amount of the transactions,
- (b) the amount of outstanding balances, including commitments, and:
 - (i) their terms and conditions, including whether they are secured, and the nature of the consideration to be provided in settlement; and
 - (ii) details of any guarantees given or received;
- (c) provisions for doubtful debts related to the amount of outstanding balances, and;
- (d) the expense recognised during the period in respect of bad or doubtful debts due from related parties.

The standard also requires a company to disclose separately for each category of related party⁶. The information is important for the users of financial statement in making detailed analysis of related party dealings. In addition, an entity also needs to disclose the related party relationship when control exists, irrespective of whether there have been transactions between the related parties. This information is necessary for users to understand the potential effect of the relationship on the financial statements.

RPTs disclosures are also subject to the BMLR. BMLR set a threshold to determine the materiality of RPTs that need to be disclosed by PLC. Among the thresholds set by BMLR are:

⁶ Categories of related parties include (a) the parent; (b) entities with joint control of, or significant influence over, the entity; (c) subsidiaries; (d) associates; (e) joint ventures in which the entity is a joint venturer; (f) key management personnel of the entity or its parent; and (g) other related parties.

- (a) If the percentage ratio of RPT is more than 0.25%, a PLC is required to announce the RPT to the Bursa Malaysia as soon as possible after the terms have been agreed;
- (b) For RPT with a percentage ratio of more than 5%, a PLC must send a circular containing the prescribed information to the shareholders, obtain shareholders' approval at a general meeting and an independent advisor should be appointed to comment on whether the RPT is fair and reasonable and whether it is detriment for minority shareholders; and
- (c) For RPT with a percentage ratio of more than 25%, a principal advisor must be appointed to ensure that the transaction is fair and reasonable and not a detriment to minority shareholders, complies with the relevant laws, regulations or guidelines, is fully disclosed in the announcement and circular, and obtains all the necessary approvals. All interested parties must abstain from voting the resolution in respect of the RPT at the general meeting.

2.3 Perspective on Related Party Transactions: Conflict of Interest or Efficient Transaction?

RPTs are perceived in the literature as a "double-edged sword", according to two opposite views: (a) conflict of interest hypothesis put forth by the agency theory; and (b) efficient transaction hypothesis in the efficient contracting theory. These two conflicting views suggest different effects of the potential costs and benefits associated with RPTs.

2.3.1 Conflict of Interest Transaction

The conflict of interest hypothesis views RPTs as potentially harmful transactions and that these dealings are inconsistent with shareholder wealth maximization. This view is consistent with the agency problem raised by Berle and Means (1932) and Jensen

and Meckling (1979). In dispersed ownership structures, concerns about RPTs can arise because of the conflict of interest between corporate managers (agents) and shareholders (principals). However, in concentrated ownership systems, conflict of interest occurs when there is a divergence between the interests of the controlling shareholders (principals) and the interests of minority shareholders (principals). The conflict of interest hypothesis predicts that in both types of ownership structures, the powerful controlling managers or the controlling shareholders can use RPTs as an instrument to expropriate wealth at the expense of unrelated parties (Cho & Lim, 2018; Gordon et al., 2004; Kohlbeck & Mayhew, 2010; Nekhili & Cherif, 2011).

According to the CFA Institute (2009), expropriation of wealth occurs when controlling shareholders use their power to divert resources away from their companies. In the corporate finance literature, this phenomenon is commonly referred to as “tunneling” (Johnson, La Porta, Lopez-de-Silanes, & Shleifer, 2000) or “self-dealing” (Djankov et al., 2008). The complexity and multifaceted nature of RPTs have created problems in monitoring and auditing these dealings, and thus providing the opportunity for managers or controlling shareholders to be engaged in self-serving behaviours that are harmful to the interest of minority shareholders (Ariff & Hashim, 2014). Accordingly, the expropriation of minority shareholders has become a major problem especially in emerging markets and has caused widespread concern in the academic literature (Bhuiyan & Roudaki, 2018).

Gordon et al. (2004) pointed out that RPTs can undermine management fiduciary responsibility to the company and directors’ monitoring function. RPTs can also alter the reliability of financial statements, thereby decreasing the effectiveness of contracts

designed to reduce agency conflict (Kohlbeck & Mayhew, 2010). Consequently, RPTs are seen as potentially detrimental to minority shareholders and hence reduce firm outcomes (Gordon et al., 2004). This conflict of interest hypothesis is supported by empirical studies, which found that RPTs are associated with greater earnings management and higher likelihood of financial fraud (Aharony et al., 2010; Chen et al., 2011; Gordon et al., 2004; Munir & Mohd Salleh, 2009).

Healy and Whalen (1999) highlighted that managers can manipulate reported earnings by structuring transactions such as RPTs to alter a firm's financial performance and position. McCahery and Vermeulen (2005) argued that the relationship between the involved parties in the transactions could influence the way RPTs operate. For instance, managers or controlling shareholders can use their control positions to sell assets, goods or services to related parties at an inflated price or purchase them at a reduced price. They can also obtain loans on favourable terms or can dilute the ownership of minority shareholders by acquiring new shares issued by the company at preferential prices (Johnson et al., 2000; La Porta et al., 2000). Profits or assets from these transactions are then transferred between group members immediately (Nekhili & Cherif, 2011). Consequently, this practice would result in RPTs-based earnings management.

Chen et al. (2011) argued that the conflicts of interests between controlling and minority shareholders are the root cause of RPTs-based earnings management practices in Chinese IPOs. They documented that controlling shareholders structure operating RPTs in pre-IPO period and that RPTs are associated with accrual earnings management. However, after the IPO period, the propping behavior decrease and the

decline of operating RPTs contributes to firms' post-IPO performance deterioration in the long term and negatively affects firms' stock return. Their results are consistent with the extant literature of earnings management via RPTs in Chinese listed firms. Aharony et al. (2010) found that Chinese IPO firms used related sales of goods and services opportunistically to manage earnings upwards in the pre-IPO period. They argued that the main motive behind managers' opportunistic behavior is for tunneling opportunities in the post IPO. Jian and Wong (2010) reported that Chinese firms prop up earnings by using abnormal related sales to their controlling owners. The tunneling activity was more pronounced for group-controlled firms. They emphasized that when there are incentives to meet earnings targets, related sales are used to reduce the effects of negative industry shocks on firms' earnings.

The evidence of earnings management through RPTs are also documented in other countries. For example, Thomas et al. (2004) suggested that Japanese parent firms use RPTs with their affiliated firms to manage their earnings. Gordon and Henry (2005) revealed related parties in the U.S. may engaged in certain types of RPTs such as fixed-rate financing from related parties, if they have incentive to manage earnings either to justify (or increase) the perquisites or possibly to mask such expropriation.

2.3.2 Efficient Transaction

In contrast with the conflict of interest hypothesis, the efficient transaction hypothesis views RPTs as efficient transactions that can fulfill underlying economic needs of the company as they can compensate for market imperfections. Because parties involved in RPTs have a relationship built on trust, they have the ability to share confidential information freely. As outlined by this hypothesis, RPTs are "benign" or potentially

value-creating transactions (Gordon et al., 2004; Kohlbeck & Mayhew, 2010), especially in institutional settings with inefficient capital, labour and product markets, like in many developing countries. Many RPTs are a normal feature of commerce and business as firms conduct their business and operations through subsidiaries, associates, joint ventures or affiliates. If firms are prohibited from entering into RPTs, they may be unable to maximise shareholders value. Thus, RPTs cannot simply be regarded as transactions serving fraudulent or deceptive purposes since many RPTs represent sound business exchanges that fulfill the economic needs of the firm (Gordon & Henry, 2005; Gordon, Henry, Louwers, & Reed, 2007). Moreover, Gordon and Henry (2005) suggested that as a “bonding mechanism”, RPTs would tie the interested parties to company, reducing their tendency to take risky transactions such as earnings management that might jeopardize the company or the related party’s relationship with the company.

In certain cases, RPTs can be used as an instrument for company to retain skilled and knowledgeable executive, which in turn, improve firm performance. Moreover, RPTs between members of a business group can be cost-effective because they help lower cost of transactions, reduce hold-up problems and increase the enforcement of property rights and contracts (Coase, 1937). Since RPTs are carried out between related parties that are subject to common control, costs of transactions can be reduced, and the negotiation contracts can be done more quickly than dealings with non-related parties (Utama et al., 2010; Utama & Utama, 2014). RPTs among firms within the same business group can also effectively deal with problems caused by the market imperfections, particularly in improving intra-group resource allocation.

Controlling shareholders sometimes used RPTs to “prop up” their financially distressed firms or firms that are in need of funds (Ying & Wang, 2013). Friedman et al. (2003) used the term “propping” or “negative tunneling” to explain the situation in which controlling owners use their private funds to provide financial support to troubled firms, thereby benefiting minority shareholders in those firms. Similarly, Riyanto and Toolsema (2008) interpreted propping as “reverse tunneling”; they pointed out that propping is used by the controlling family to save firm from bankruptcy, which is beneficial for investors. Thus, the presence of propping acts as a kind of insurance for minority shareholders.

Mitton (2002) provided evidence that during the 1997–1998 Asian financial crisis, diversified firms in Indonesia, Korea, Malaysia and Thailand engaged in propping to support financially distressed affiliated firms. Using connected transactions data from China, Peng, Wei, and Yang (2011) showed that controlling parties in financial distress firms are more likely to conduct RPTs to prop up their firms and that market reacts positively to the announcement of RPTs. Another study by Jian and Wong (2010) indicated that controlling shareholders in Chinese listed firms use related party sales to meet regulators' earning targets either to avoid delisting or to qualify for rights offering. In short, the above studies show that controlling owners do not always use RPTs for their own interests but instead, for the benefit of the firm as a whole.

2.4 Research on Related Party Transactions

RPTs have received attention among researchers after the revelation of many corporate scandals. The scandals highlighted that RPTs are the main channel used by controlling parties to expropriate minority shareholders (Munir et al., 2013). Johnson et al. (2000)

used the term “tunneling” to describe the expropriation activities by controlling owners. Most existing studies used indirect proxies to measure the degree of these expropriation acts (e.g. Bae, Kang, & Kim, 2002; Bertrand, Mehta & Mullainathan, 2002; Claessens et al., 2002; Faccio, Lang, & Young, 2001; Friedman et al., 2003; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2002). Some studies used the legal system (Johnson et al., 2000; La Porta et al., 2002), the deviation of cash flow from control rights (Claessens et al., 2002; Lemmon & Lins, 2003) or dividend payouts (Faccio et al., 2001; La Porta et al., 2000) as a proxy for the likelihood of expropriation of minority shareholders. Even though these studies provide useful information, they are unable to provide direct evidence on how much the value of minority shareholdings has declined due to specific acts of expropriation (Cheung et al., 2006).

Recent studies instead focus on RPTs as a direct measure through which expropriating activities may occur (e.g. Berkman, Cole, & Fu, 2009; Cheung et al., 2006, 2009; Gordon et al., 2004; Jian & Wong, 2010). Studies in this field use either total (aggregate) amount of RPTs (Abdul Wahab et al., 2011) or focus on specific types of RPTs (Antonios, Ioannis, & Panagiotis, 2011; Ge et al., 2010; Yeh, Shu, & Su, 2012) disclosed in the corporate annual reports, filings and circulars as a measure of wealth expropriation. This section discusses prior studies conducted both locally and internationally, in relation to RPTs.

2.4.1 Related Party Transactions – Malaysia Studies

In Malaysia, the topic of RPTs is relatively less studied. Only recently have a few empirical studies (e.g Abdul Wahab et al., 2011; Al-Dhamari, Al-Gamrh, Ku Ismail, & Haji Ismail, 2017; Arshad, Darus, & Othman, 2009; Haji Abdullah & Wan Nordin,

2015; Hasnan et al., 2016; Munir & Gul, 2010; Munir et al., 2013) emerged to explore the issue of RPTs. Arshad et al. (2009), who examined the the effects of IFRS on the extent of RPTs disclosure in two disclosure regimes (2002 and 2007), are among the pioneers in this area. RPTs disclosure is measured as the total number of words reported by companies in relation to RPTs. They found a significant increase in the extent of RPTs disclosure in 2007, suggesting that the adoption of IFRS would improve corporate disclosure transparency especially in countries with concentrated ownership structure. They also found that firms with higher proportion of board members possessing accounting professional affiliations are more likely to disclose higher number of words regarding RPTs, suggesting that they can enhance monitoring effectiveness.

Munir and Gul (2010) investigated the association between RPTs and firm performance. Based on a sample of 462 firms in 2004 and 2005, they found that RPTs reduce firm performance, suggesting that such transactions can be used by controlling shareholders to expropriate minority shareholders. They also found that the expropriation is more prevalent in Malaysia family firms compared to non-family firms. In another paper, Munir et al. (2013) investigated a sample of 236 firms in 2004 to find the effects of RPTs on earnings quality of family firms in Malaysia. Their result provided evidence of non-linear relationship between family ownership and earnings quality for companies with substantial RPTs. Specifically, the results document that when companies have smaller level of family ownership, they tend to report high earnings quality, indicating that families are less likely to conduct abusive RPTs. However, when family ownership has high level, RPTs appear to negatively affect firms' earnings quality, which in turn inversely affect the relationship between

earnings quality and family ownership. Both findings of Munir and Gul (2010) and Munir et al. (2013) supported the conflict of interest view of RPTs suggesting that the transactions are harmful to minority shareholders.

Studies by Munir and Gul (2010) and Munir et al. (2013) have been extended by Abdul Wahab et al. (2011). Using 448 firms-year samples for the period of 2005–2007, Abdul Wahab et al. (2011) examined the moderating effects of corporate governance attributes on the RPTs-firm performance relationship. The main source of RPTs data in their study is different from Munir and Gul (2010) and Munir et al. (2013). Abdul Wahab et al. used circulars sent to the shareholders while both Munir and Gul (2010) and Munir et al. (2013) utilised companies' annual reports. The result revealed a negative relationship between RPTs and firm performance, thus support conflict of interest hypothesis. In addition, they found that the presence of high quality of corporate governance practices: the proportion of board independence, executive remuneration and the presence of a Big-4 auditor, lessens the negative effect of RPTs and thus enhance firm performance.

Haji Abdullah and Wan Hussin (2015) investigated the relationship between RPTs, audit committee characteristics and real earnings management and the moderating effect of family ownership on the RPTs-earnings management relationship. Their results are consistent with the conflict of interest view that RPTs increase earnings management. For audit committee characteristics, they found that only financial expertise plays an important role in alleviating opportunistic real earnings management. They also found that the impact of potentially expropriating RPTs on

real earnings management is moderated by family-controlled firms, suggesting that family firms are less likely to engage in opportunistic earnings management.

Hasnan et al (2016) investigated the moderating effects of internal and external corporate governance on RPTs-earnings quality relationship. Their study shared the same method used by Abdul Wahab et al. (2011) in collecting RPTs data, which was by referring to circulars to shareholders. Based on 294 firm-year samples for 2011–2012, they found that firms with RPTs are associated with lower earnings quality and thus support the notion that RPTs are detrimental to shareholders. They also found that the level of board independence and audit quality weaken the negative effects of RPTs on earnings quality.

Study by Al-Dhamari et al. (2017) provided more recent evidence of RPTs in Malaysia. Unlike other studies that focused on the impact of RPTs on firm value or firm performance, Al-Dhamari et al. examined the relationship between RPTs and audit fees and determined whether the relationship is weakened by greater investment in the internal audit function. They found that audit fees were determined based on audit risks and efforts required to untangle the RPTs. Specifically, their results showed that audit fees are higher for firms that undertake RPTs sales and purchases, indicating that they are abusive transactions and therefore, require greater audit efforts. However, the positive relationship between RPs sales and purchases is weakened for firms with a high quality of internal audit function, suggesting that internal audit function play an important role in limiting abusive RPTs sales and purchases, which in turn reduce audit efforts and risks.

To sum, the main sources of RPTs data in the aforementioned studies are either from circulars to shareholders or companies' annual reports. Agency theory has been used in these studies as the main theoretical framework. These studies provide evidence that RPTs are harmful to shareholders and thus support the conflict of interest perspective. The results indicate that in Malaysia, RPTs provide channels for controlling shareholders to extract corporate resources from minority shareholders. However, these studies are limited in the sense that the researchers ignored the various types of RPTs or types of parties involved in RPTs. Focusing on general RPTs only are inadequate to capture the various nature of RPTs. Abdul Wahab et al. (2011), Cheung et al. (2006) and Kohlbeck and Mayhew (2010) argued that the potential benefit or detriment depends on the types of RPTs or types of related parties. Hence, categorizing RPTs based on types of transactions or related parties and testing them separately, as suggested by previous research, is a more valuable research approach in scrutinizing RPTs.

Moreover, in moderating effects of corporate governance studies conducted by Abdul Wahab et al. (2011) and Hasnan et al. (2016), the researchers mostly focused on board structure such as board size and board independence. These studies, however, ignored the role of directors' HC and SC that are argued to directly relate to the ability of board in performing monitoring and advising roles (Hillman & Dalziel, 2003). Therefore, to provide complete understanding of how the board members affect firms' outcome, future studies that examine board effectiveness are suggested to integrate research on boards of directors with HC and SC perspectives.

2.4.2 Related Party Transactions – International Studies

Studies on RPTs are mostly conducted in developed countries and China. The literature focuses mainly on several areas, including economic consequences of RPTs (e.g., Cheung et al., 2006; Downs, Ooi, Wong, & Ong, 2016; Elkelish, 2017; Ge et al., 2010; Kohlbeck & Mayhew, 2010; Nekhili & Cherif, 2011; Ryngaert & Thomas, 2012), factors associated with motivations behind RPTs (e.g., Aharony et al., 2010; Jian & Wong, 2010; Kang, Lee, Lee, & Park, 2014; Peng et al., 2011; William & Taylor, 2013), the effect of corporate governance and regulations on RPTs (Gallery et al., 2008; Gordon et al., 2004; Utama & Utama, 2014; Yeh et al., 2012), and the effect of RPTs on audit fee (Habib, Jiang, & Zhou, 2015; Kohlbeck & Myhew, 2017). These studies examined RPTs in three different areas: (1) RPTs disclosure (e.g., Elkelish, 2017; Utama & Utama, 2014), (2) RPTs in general, for example, based on the aggregate number or amount of RPTs (e.g., Dahya et al., 2008), (3) specific RPTs, for example, related party sales, related party purchases, and related party payables (e.g., Gao & Kling, 2008; Wang & Yuan, 2012; Wong et al., 2015), and (4) broader scope of RPTs, for example, the related parties of the transactions and the nature of the transactions (e.g., Cheung et al., 2009; Kohlbeck & Mayhew, 2010; 2017; Nekhili & Cherif, 2011; Peng et al., 2011).

Related Party Transactions Disclosures

Most studies in this area are conducted in a single country setting such as Indonesia, United Arab Emirates (UAE), China and Greece. Based on 341 firms listed on the Indonesian Stock Exchange (IDX) in the year 2006, Utama and Utama (2014) investigated the determinants of RPT disclosures in Indonesia. The extent of RPTs disclosures was measured based on disclosure requirements of Indonesian Capital

Market and Financial Institutions Supervisory Agency (Bapepam-LK) Rule VIII.G. 7: *Guideline for the Preparation of Financial Statements*. They provided evidence that the level of RPTs disclosures is positively affected by corporate governance practice and size of RPTs. The finding supports prior research that corporate governance practice as an internal monitoring mechanism decreases asymmetric information and agency problem.

Focusing on the 1997-2003 annual reports of 52 manufacturing firms in China, Ge et al. (2010) examined whether RPTs disclosures under the new regulation in 2001 provided value relevant information to investors. Their study focused on two types of RPTs: sales of goods and sales of assets. These RPTs were measured using dummy variables. From 1997 to 2000, they found that the listed companies used related party sales of goods and assets to manage earnings. The result however, was not observed during 2001–2003 after a new fair value measurement rule for RPTs came into effect, suggesting that the new RPT regulation is perceived to be effective at reducing the potential misuse of RPTs for earnings management purposes.

Similar research on the value relevance of RPTs was conducted in Greece. Antonios et al. (2011) examined the value relevance of the disclosure of related party sales of goods and assets in Greek companies before and after the adoption of International Financial Reporting Standards (IFRS). Their testing periods were separated into three sub periods: period prior to adoption of IFRS's (2002-2004), period to change the accounting principles and rules (2004-2005), and period after the adoption of IFRS (2005-2007). Their results are consistent with Ge et al. (2010). In particular, Antonios et al. found that the new accounting standards, which require fair value measurement

rule of RPTs, resulted in less market discounting of firms engaged in related party sales transactions than those firms without such transactions. The results suggested that the new RPTs regulation in Greece could potentially reduce the negative effects of RPTs.

Elkelish (2017) examined the relationship between RPTs disclosure and firm valuation in the UAE companies during the period of 2008–2012. RPTs were measured based on the IFRS (IAS 24) disclosure index. He contended that the utilization of index to measure RPTs would help in: (a) enhancing comparability between firms; (b) resolving conflicting findings; (c) streamlining common understanding of RPTs; and (d) encouraging the adoption and convergence of IFRS. The agency, information asymmetry and signaling theories were employed in this study. Elkelish found that RPTs disclosure affect firm valuation negatively, and the effect was more pronounced for transactions involving subsidiaries and associate. The results indicated that RPTs can be used to expropriate minority shareholders and flexible compliance with IFRS may initiate concern on the abusive RPTs.

General RPTs

RPTs in this area are measured either using the number/amount of RPTs or using a dummy variable (i.e. 0/1 indicator). Dahya et al. (2008), based on 799 firms with some dominant shareholders in 22 countries, examined the relationship between the occurrence of RPTs (based on dummy variable) and the proportion of INEDs and the impact of RPTs on firm value. They argued that controlling shareholders who have higher power and lower cash flow rights have stronger incentives to divert corporate resources to other companies. Therefore, the presence of higher number of INEDs on the board was expected to limit the degree of such diversion. Their findings

documented an inverse relationship between the proportion of INEDs and the number of RPTs and between RPTs and firm value. The results suggested that INEDs may be able to monitor firm's dominant shareholders and thus can reduce the ability of the dominant shareholders to generate private benefits.

In an Indonesian study, Utama and Utama (2009) investigated stock market reactions to the announcement of RPTs during the period of 2005-2007. Market reaction was measured by Cumulative Abnormal Return (CAR) and a dummy variable (0/1) was used to measure whether the announcement of RPTs provided information on the value of RPTs. Contrary to other studies (e.g., Cheung et al. (2006) in Hong Kong; Cheung et al. (2009) in China), they did not find any significant difference in market reaction between RPTs and non-RPTs announcements. The finding suggests that in a country with inefficient external market, the benefits of RPTs may outweigh the costs associated with RPTs.

Using a sample of 215 firm-year observations from 84 firms listed in Athens Stock Exchange between 2009 and 2011, El-Helaly (2016) investigated the relation between RPTs and accounting quality. Consistent with Ryngaert and Thomas (2012), this study used a dummy variable for RPTs that took a value of one if the sum of RPTs exceeded 1% of the firm's total assets, and zero otherwise. The results failed to support the prediction that RPTs firms exhibit more earnings management than those without RPTs, suggesting that RPTs are not always used for opportunistic earnings management.

Specific Related Party Transactions

Some studies focus on specific RPTs such as related party sales and purchases, related party loans, related party receivables and payables. Focusing on related party sales of goods and services, Wong et al. (2015) examined whether these RPTs by Chinese listed firms enhance or reduce firm value. They found that in general, related party sales enhance firm value. The result was thus in line with the view that RPTs can be used to improve resource allocation efficiency. However, further analysis showed that the positive effect disappeared for firms with substantial percentage of parent directors and government ownership.

From the perspective of earnings management, Aharony et al. (2010) examined whether related party sales and purchases are used by the Chinese listed companies to manage earnings during the initial public offering (IPO) process. The findings showed that companies engaged in related party sales of goods and services to prop up earnings prior to the IPO period and tunneled for the benefit of the parent company in the post-IPO period. Jian and Wong (2010) also examined related party sales, but their focus was on listed firms rather than IPOs. They found that the most common motive behind such transactions was to meet earnings targets. These transactions were more prevalent among state-dominated firms and in countries with weak economic institutions. In another study of Chinese firms, Wang and Yuan (2012) examined the impact of related party sales of goods and services on the usefulness of earnings and on the earnings forecasts quality by financial analysts. They found that earnings informativeness tend to be lower for firms engaging in related party sales of goods and services. They also documented that analysts in firms with more RPTs sales provide less accurate earnings forecasts. Their results support the view that RPTs sales may

violate the arm's-length principle and consequently impair the usefulness of accounting data.

Related party loans are another types of RPTs that has been the focus of several studies such as Berkman et al. (2009), Cullinan, Du, and Wright (2006) and Kahle and Shastri (2004). Berkman et al. (2009) examined related party loan guarantees for Chinese listed firms in 1999. Related party loan guarantees are found to be less frequent in smaller firms, profitable firms and firms with higher growth. Further test revealed that loan guarantees have a negative effect on firm value and dividend yields. The results provide support to the action taken by Chinese Securities regulators to ban loan guarantees.

In the US setting, Kahle and Shastri (2004) examined the characteristics and the efficacy of using executive loans. Based on a longitudinal time frame from 1996-2000, they found that the characteristics of the loans depend on their intended purpose. Specifically, their results show that loans for personal home and relocation are offered at below market rate, suggesting a tunneling effect. However, loans for stock purchase and option exercise are found to be beneficial in increasing executives' ownership, thereby aligning the interest of managers and shareholders (i.e. the efficient-transaction view). These findings lead Kahle and Shastri to question the appropriateness of the Sarbanes-Oxley Act's loan prohibition.

In another study of US firms, Cullinan et al. (2006) examined whether executive loans in the pre-Sarbanes-Oxley period are associated with financial misstatements. Their results were not in line with Kahle and Shastri (2004). Specifically, based on 106 firms

with financial misstatements during the late 1990s and early 2000s, Cullinan et al. found a significant association between executive loans and financial misstatements, suggesting that loan prohibitions of the Sarbanes-Oxley are consistent with the Act's overall objective of improving the accuracy and reliability of corporate financial reporting. They argued that study by Kahle and Shastri was limited in scope because they did not consider the potential effects of executive loans on financial reporting accuracy.

Other studies focus on the difference between accounts receivable and payable to related party (Gao & Kling, 2008) and other receivables (Jiang, Lee, & Yue, 2010) to measure the extent of tunneling. Gao and Kling (2008) provided evidence that good corporate governance mechanisms (i.e. outsiders in the board of directors, audit without non-clean opinion and dispersed ownership) are associated with less tunneling and asset appropriation in China. Focusing on other receivables, Jiang et al. (2010) provided direct measure of tunneling. In their study, other receivables were used as a proxy of tunneling because the suspected tunneling is argued to be carried out via inter-
corporate loans and these transactions are typically disclosed as part of other receivables in China. The study documents the extensive use of corporate loans by controlling shareholders to transfer funds from Chinese listed companies. They further found that high quality auditors, institutional investors, and regulations could mitigate tunneling behavior.

Broader Scope of Related Party Transactions

Most of the studies in this area either focus on the nature of RPTs or on the related party of the transactions. Using a sample of 112 listed companies in 2000 and 2001,

Gordon et al. (2004) offered a comprehensive study of RPTs in the US. Data on RPTs including number, types of transactions, and types of related parties were hand-collected from both the proxy statements and the 10-K's of each company in the sample. They classified RPTs into two broad categories: parties involved (including executives, non-executive board members, major shareholders, and subsidiaries) and types of transactions (including employment/direct services between related parties or the related party and the company, purchases of goods or services from the related party, sales to the related party, loans to or from the related party, investments, and others). The findings indicate that RPTs do not serve shareholders' interest, thus support the argument that such transactions represent a conflict of interest between managers and shareholders. They also found that the negative effect of RPTs on firm value is more pronounced for loans to executives and non-executives and other transactions with non-executive directors, namely purchases of goods and services and direct services.

In another US study, Kohlbeck and Mayhew (2010) examined the valuation implication of RPTs disclosures on the S&P 1500 in 2001, prior to the issuance of Sarbanes-Oxley Act. They argued that RPTs disclosure could provide market participants with information necessary for investors to discipline opportunistic behavior. RPTs are classified into three broad categories: loans, other simple transactions and complex strategic transactions. They also classified RPTs according to the related party to the transactions (i.e. RPTs with a director, officer, and shareholder or with unconsolidated investment of the firm). The results show that firms that disclose RPTs are associated with lower stock returns and negative market values compared to non-RPTs firms. With regards to the nature and types of related

parties, they found that the negative effect on stock returns and firm values is mainly driven by loans and simple transactions with directors, officers and shareholders. Moreover, their study provides evidence that weak corporate governance practices lead to more frequent RPTs.

In a latest study by Kohlbeck and Mayhew (2017), RPTs were categorized into separate “Tone” and “Business” groupings. Tone RPTs included transactions, such as loans, guarantees, and consulting arrangements, with a director, officer, or major shareholder and these transactions are considered opportunistic RPTs. Business RPTs included purchase and sales of product central to the operations of the company and are commonly transactions with investees of the company and they are considered as efficient contracting. They provided evidence that different types of RPTs could signal whether company insiders appear to use their power to engage in opportunistic behaviours or the transactions are the result of efficient contracting. Tone RPTs are significantly associated with restatement, suggesting these transactions are red flags for an increased risk of material misstatement. They also found that RPTs are associated with lower audit fee.

Based on 234 US firms, Ryngaert and Thomas (2012) examined how the timing of RPTs (i.e. ex-ante RPTs and ex-post RPTs) affected firm value. Ex ante RPTs refer to transactions entered before the counterparty becomes a related party. Ex post RPTs, on the other hand, are transactions occurring after the counterparty obtains related party status. They found that the nature and timing of RPTs influences the wealth effect of RPTs. Their results specifically show that in general, RPTs do not affect firm value, thus support the argument of “benign transactions”. However, further test reveals ex-

ante RPTs are not associated with firm performance (measured by operating performance) but positively associated with firm value (measured by Tobin's Q). However, ex-post RPTs are inversely associated with firm performance and value and are also associated with an increased likelihood that a firm will either encounter financial distress or deregister its securities. The results are consistent with ex post RPTs being opportunistic.

Cheung et al. (2006; 2009), in their studies on China and Hong Kong, classified RPTs into two categories: potentially "ex-ante potentially tunnelling transactions" and "ex-ante potentially propping transactions". The former includes: (i) acquisitions of assets (including shares) by the listed company from related parties; (ii) asset sale by the listed company to related parties; (iii) asset swaps between the listed company and its controlling shareholder; (iv) trade of goods or services between the listed company and its controlling shareholder; and (v) direct cash payments, loans or provision of loan guarantees by the listed company. The ex-ante potentially propping RPTs include: (i) direct cash assistance, loans or loan guarantees provided by the related party to the listed company; and (ii) transactions between the listed company and its non-listed subsidiaries.

The objective of their studies was to examine the potential for both tunneling and propping up activities by controlling shareholders in China and Hong Kong. They provided evidence that RPTs could be used to expropriate minority shareholders via tunneling activities both in China and Hong Kong. In particular, focusing on the companies listed in the Stock Exchange of Hong Kong, Cheung et al. (2006) found that minority shareholders experience significant value losses both at the initial and in

the subsequent 12-month period after the announcement of RPTs. In China, Cheung et al. (2009) documented a limited evidence of propping through RPTs. Firms subject to propping up are more likely to have foreign shareholders and to be cross-listed abroad compared to tunneling firms.

In the French context, Nekhili and Cherif (2011) examined the impact of RPTs on firm value. The study was carried out on a sample of 85 French companies listed on the Paris Stock Exchange from 2002 to 2005. RPTs were distinguished between RPTs with subsidiaries and associated companies and RPTs with the main shareholders, directors or managers, and the companies with which they are affiliated. They found that RPTs are mainly influenced by the voting rights held by the main shareholder, board size, board independence, leverage and the US listing status. RPTs involving directors, officers and major shareholders are found to have a negative influence on firm value.

2.5 Scope of Independent Directors

2.5.1 Definition of Independent Directors

The board of directors of PLCs in Malaysia consist of executive and non-executive directors. As shown in Figure 2.2, non-executive directors, comprising independent and non-independent director, play a crucial oversight role and he/she is considered the last line of defence against corporate wrongdoings. Non-executive directors are not full-time directors and are not involved in the operational and management aspects of the company. Thus, for INEDs to be kept informed of a company's operations, they have to regularly attend board meeting (Masulis, Wang, & Xie, 2012). Such

attendance is evidence of their commitment to monitor top management (Cai, Garner, & Walkling, 2009).

INEDs are formally defined in paragraph 1.01 of the BMLR as a director who is independent of management and free from any business or other relationships which could interfere with the exercise of independent judgement or the ability to act in the best interests of the company. An INED is one who:

- a) is not an executive director of the company or any related corporation of the company.
- b) has not been within the last 2 years and is not an officer (except as a non-executive director) of the company.
- c) is not a major shareholder of the company.
- d) is not a family member of any executive director, officer or major shareholder of the company.
- e) is not acting as a nominee or representative of any executive director or major shareholder of the company.
- f) has not been engaged as an advisor by the company under such circumstances as prescribed by BMLR or is not presently a partner, director (except as an INED) or major shareholder, as the case may be, of a firm or corporation which provides professional advisory services to the company under such circumstances as prescribed by BMLR.
- g) has not engaged in any transaction with the company under such circumstances as prescribed by BMLR or is not presently a partner, director or major shareholder, as the case may be, of a firm or corporation (other than subsidiaries of the applicant

or listed issuer) which has engaged in any transaction with the said corporation under such circumstances as prescribed by the BMLR.

Any non-executive director that falls outside the Bursa's Malaysia definition of INEDs is classified as non-independent director. The demand for INEDs in Malaysia has risen due to the requirement for a company to form the sub-committees of audit, remuneration and nomination as the members of such committees must consist of INEDs (MCCG, 2000). The substantive involvement of INEDs in these committees are expected to provide a relevant check and balance mechanism for the company. Specifically, being members of the Audit Committee, INEDs are expected to assist and to evaluate the appropriateness of a company's financial reporting, internal control systems, risk management systems and the internal and external audit. On the Remuneration Committee, INEDs play an important role to assist the board relating to executive remuneration plans and to ensure the remuneration packages are sufficient. On the Nomination Committee, INEDs have a duty in overseeing the selection and assessment of a company's directors. Therefore, to fulfill the above-mentioned roles and responsibilities, INEDs are required to possess adequate knowledge and expertise.

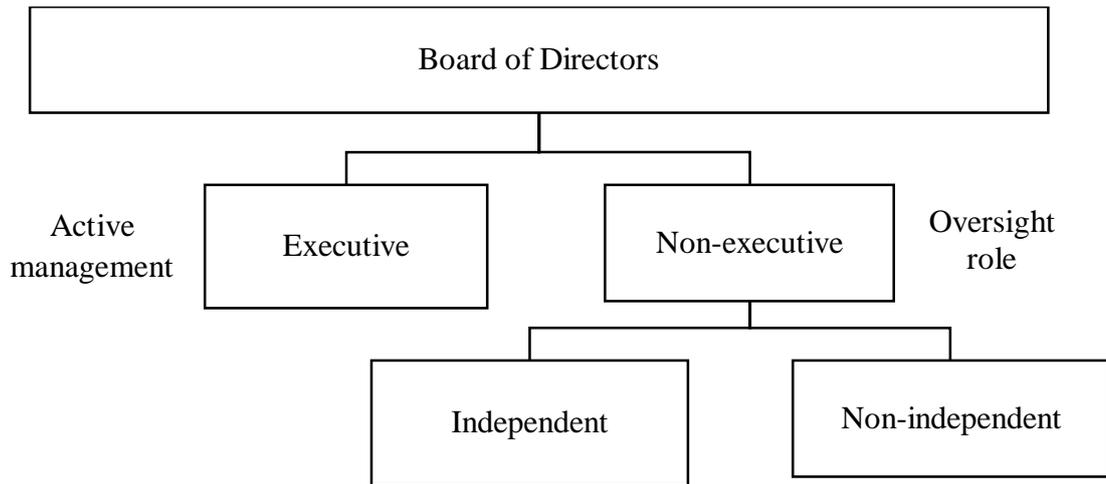


Figure 2.2
Classification of Board of Directors in Malaysia
 Source: KPMG, 2013

2.5.2 The Appointment Process of Independent Directors in Malaysia

The appointment process of directors including INEDs is one of the critical aspects to ensure that the board consists of members with diverse skills, knowledge and expertise. Therefore, the procedure for appointment of directors should be made formal and transparent. To be appointed as a director, the proposed director must satisfy the “fit and proper” requirement. The MCCG 2000 recommended that Malaysian PLCs to establish a Nominating Committee comprising exclusively of non-executive directors, with the responsibilities of overseeing the selection and assessment of directors. The Code was then revised in 2007 to provide greater clarity and guidance on the eligibility criteria for appointment of directors, the composition of the board of directors and the role of the nominating committee.

Currently, the majority of Malaysian PLCs have prescribed the process for appointing the directors, in the corporate governance statements of their annual reports. Figure 2.3 shows the procedures of INEDs’ appointments as disclosed by IHH Healthcare

Berhad in its annual report. The Nominating Committee (NC) first identifies the suitable candidate to be appointed as a director. The candidate is then assessed based on certain criteria such as knowledge, diversity, commitment, experience and integrity which the directors could bring to the board. Then, the Nominating Committee evaluates and matches the criteria of the candidate with the skills and knowledge required by a firm. The board finally approves the appointment of new director after considering the recommendations of the Nominating Committee. According to Abdullah, Zainal Abidin, Abu Bakar, and Rahman (2016), the sources of INEDs in Malaysia come from proposal from the board of directors, controlling shareholders, the CEO and advertisement or recruitment agency.



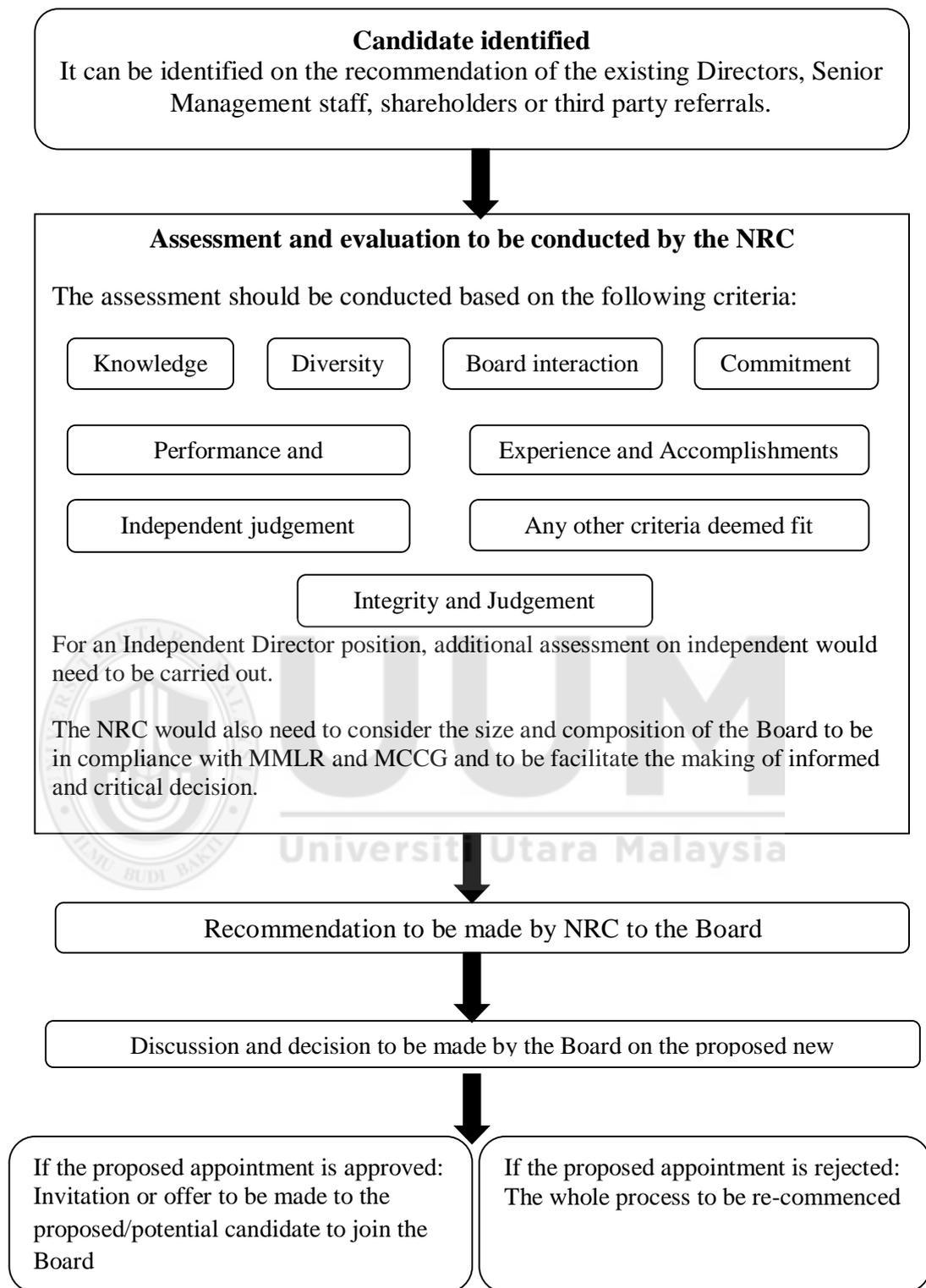


Figure 2.3
INEDs Appointment Process in IHH Healthcare Berhad
 Source: IHH Healthcare Berhad, 2015, p. 134

2.5.3 Rules and Guidelines Relating to Independent Directors in Malaysia

In Malaysia, the importance of INEDs as governance mechanism has received substantial attention following the 1997/1998 Asian crisis. Consistent with the argument of agency theory, INEDs are seen as an appropriate mechanism to mitigate the agency conflict between controlling parties and minority shareholders. Consequently, numerous efforts have been taken by the Malaysian government to strengthen the role of INEDs. The requirement for the board of directors of Malaysian PLCs to consist of INEDs is clearly stated in the MCCG and BMLR.

The MCCG was first issued in March 2000. The Code is mainly based on the recommendations of the 1992 Cadbury Report and the 1998 Hampel Report in the United Kingdom. There are four main parts in the MCCG's recommendations: Part (1) Principles of Corporate Governance; Part (2) Best practice in Corporate Governance; Part (3) Principles and Best Practices for other corporate participants; and Part (4) Explanatory notes. The compliance with the principles and best practices of the MCCG is on voluntary basis. To further enhance the corporate governance practices in Malaysia, the MCCG then became part of the Bursa Malaysia (formerly known as Kuala Lumpur Stock Exchange) Listing Requirements in 2001 (Abdul Wahab, How, & Verhoeven, 2007). Chapter 15 of the BMLR sets out the requirements that must be complied with by a PLC and its directors with regard to corporate governance.

The MCCG 2000 recommended that for the board to be effective, the board should include balance members with at least one-third of the board membership to be INEDs. In line with this, Chapter 15.02 of the BMLR requires a minimum of two (2) or one

third (1/3) of the board of the PLCs, whichever is higher, to be INEDs. If the number of directors of the PLC is not three (3) or a multiple of three (3), then the number nearest one third (1/3) must be used. This requirement is to ensure that the board's decision making is not dominated by a certain party. The MCCG 2000 also emphasized that INED should be persons of calibre, credibility and have the necessary skills, competencies, commitment and experience to bring independent judgement to bear on issues of strategy, performance and resources including key appointments and standards of conduct.

The MCCG 2000 was then revised in 2007 with the aims to further strengthen corporate governance practices in Malaysia in line with developments in the domestic and international capital markets. The revised MCCG mainly focused on improving the quality of the board of PLCs and strengthening the role of the audit committee. The code strongly recommended that the members of audit committee comprises non-executive directors who are financially literate and at least one should be a member of an accounting association or body. These recommendations are mandated in the BMLR. Paragraph 15.09(1)(c) of the BMLR specifically requires that at least one member of the audit committee:

- (a) must be a member of the Malaysian Institute of Accountants (MIA); or
- (b) must have at least 3 years' working experience and;
 - i) must have passed the examinations specified in Part I of the First Schedule of the Accountants Act 1967; or
 - ii) must be a member of one of the associations of accountants specified in Part II of the First Schedule of the Accountants Act 1967; or
 - iii) fulfills such other requirements as prescribed or approved by the Exchange.

The MCCG 2012, which supersedes the 2007 Code, is part of a key deliverables under the Securities' Commission 2011 Corporate Governance Blueprint. The Code stresses that given the recent spate of corporate scandals and failures, beefing up the roles and responsibility of INEDs is critical for the board to function effectively. Thus, the MCCG 2012 focused, among other, on the independence of INEDs. The board is encouraged to annually assess the independence of INEDs and such assessment should be disclosed in the company's annual report. The tenure of INEDs has been capped at 9 years, with the justification that long tenure can impair independence. After the period, such directors may serve as non-independent directors or, in exceptional cases, remain as INEDs subject to the assessment by the Nominating Committee and approval of shareholders. The MCCG 2012 also raised concern on time commitment of having multiple directorship. The Code argued that directors who sit on multiple boards are less effective in monitoring management and controlling shareholders. However, the MCCG 2012 was silent on the number of directorship that directors can hold. Referring to Chapter 15.06 of the BMLR, the listing allows directors to have up to 5 directorships in PLCs.

The new MCCG 2017 was released by the Securities Commission Malaysia and takes effect on the 26 April 2017, replacing the 2012 code. The code places greater emphasis on the internalisation of corporate governance culture by encouraging non-listed entities including state-owned enterprises, small and medium enterprises (SMEs) and licensed intermediaries to embrace the code. Strengthening the independence of the board and audit committee is among the new dimension in the code. In particular, the code requires that at least half of the board to comprise INEDs and for large companies,

there must be a majority of INEDs. It is recommended that all members of Audit Committee comprise of INEDs.

To summarize, there are a few important attributes of the INEDs that have been emphasized in the MCCG and BMLR, namely the proportion of INEDs, their financial expertise, length of tenure, and number of directorships. From the perspective of HC and SC, those characteristics are among the important attributes of board capital that can capture INEDs' skills, knowledge, experience, networking and expertise. Figure 2.4 summarises the MCCG reforms relating to INEDs.

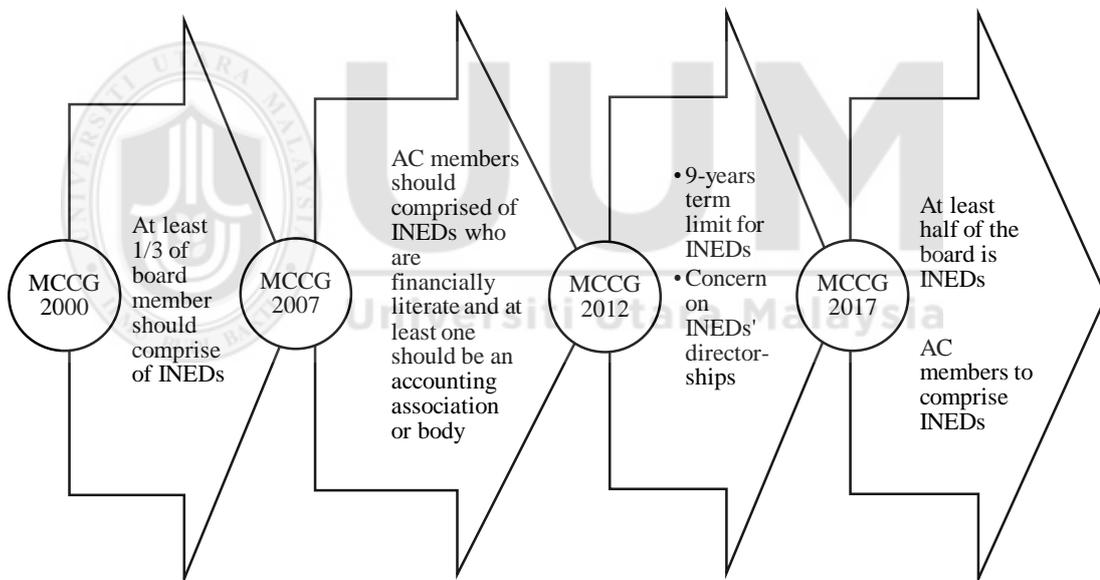


Figure 2.4
Malaysian Code on Corporate Governance Reforms Relating to INEDs

2.5.4 Roles and Responsibilities of Independent Directors

Prior studies highlighted that INEDs provide two important roles for firms: (a) Corporate monitor - monitoring managers and controlling shareholders on behalf of other shareholders (Fama & Jensen, 1983; Jensen & Meckling, 1976; Young, Peng, Ahlstrom, Bruton, & Jiang, 2008); and (b) Resource provider – providing valuable resources to the firms (Carpenter & Westphal, 2001; Field & Mkrtyan, 2017; Hillman & Dalziel, 2003; Kor & Sundaramurthy, 2009).

2.5.4.1 Monitoring Role

Monitoring is one of the crucial roles of INEDs. INEDs appear to enhance board effectiveness due to their ability to exercise independent judgement. The advocates of the agency theory argue that INEDs may serve a company by reducing the divergence of interest between management and shareholders (Type I agency problem) and between controlling and minority shareholders (Type II agency problem) (Fama & Jensen, 1983; Young et al., 2008). Improper monitoring by INEDs provides the management and controlling shareholders an opportunity to act on their own interest instead of fulfilling the interest of other shareholders. Thus, the proportion of INEDs are expected to limit the agent's self-serving behavior (Li, 1994). According to Fama and Jensen (1983), INEDs have more incentives to provide an effective monitoring of management because of the need to build and retain their reputation as decision making experts. Due to the importance of INEDs as corporate monitor, most codes on corporate governance recommend that a majority of the board should consist of INEDs.

From a corporate governance perspective, INEDs are expected to perform their monitoring role by means of sitting on a number of watch-dog committees, including

the audit, remuneration and nominating committees (Annuar & Abdul Rashid, 2015). In Malaysia, the details of their monitoring role in these sub-committees are prescribed in the MCCG. A study by Annuar and Abdul Rashid (2015) provided evidence that INEDs play a crucial role in safeguarding the interests of smaller investors. Their active involvement in the audit, remuneration and nominating committees are aimed to provide a check and balance mechanism on the board. Li (1994) argued that because directors (including INEDs) bring a mix of skills, expertise, knowledge and independence to the sub-committees and the boards as a whole, they are seen as a powerful governance mechanism that can minimize agency costs and protect the interest of shareholders.

With regards to RPTs, the role to review these transactions is normally assigned to audit committee and remuneration committee. In certain company, RPTs committee is established to review conflict of interest situations and RPTs. The majority of these committees' members are INEDs. Their specific roles are discussed below.

Audit Committee and Related Party Transactions Committee

Paragraph 15.13(h) of the BMLR highlights that the audit committee or RPTs committee should review and report to the board any RPTs and conflict of interest situations that may arise within the company or group including any transaction, procedure or course of conduct that raises questions of management integrity (BMLR, 2012). In the reviewing process, the committee should identify the interested parties and RPTs and possible conflict of interest situation.

When the audit committee receives a report on conflict of interest situations and/or RPTs report, the members should review and determine whether the conflict of interest situations or RPTs are fair, reasonable, on normal commercial terms and are not prejudicial to the interests of the company or its minority shareholders (CGG, 2009).

In making assessment, the audit committee is responsible for questioning:

- (a) whether the basis for arriving at the transaction price is on arm's length basis or terms fair to the company;
- (b) whether there are business reasons for the company to enter into RPTs and not a third party;
- (c) whether the business reasons are in line with the overall strategy and objective of the company;
- (d) what benefits the interested party will derive from the transaction;
- (e) what impact the transaction will have on the financial statements; and
- (f) whether there is economic substance in entering into the transaction.

The audit committee is also responsible for ensuring that management establishes a comprehensive framework for the purposes of identifying, monitoring, evaluating, reporting and approving RPTs. It may request the internal auditor or other external consultants to review the effectiveness, adherence to and relevance of the framework (CGG, 2009).

Remuneration Committee

The remuneration committee is responsible for ensuring that all the executive directors, CEO (where the CEO is not a director of the company) and senior management are fairly rewarded for their individual contributions to the company's

overall performance (CGG, 2009). One of the remuneration committee's main duties is to develop a framework on the fee structure and level of executive remuneration. It should ensure that the remuneration framework is robust and effective enough in the following areas:

- (a) attracting and retaining key personnel of requisite quality that increases productivity and profitability in the long run;
- (b) motivating and creating incentives for directors to perform at their best; and
- (c) focusing attention on the achievement of desired goals and objectives.

2.5.4.2 Resource Provider

Resource dependence scholars argue that besides being a corporate monitor, INEDs are expected to provide critical resources to the firms (Hillman, Withers, & Collins, 2009; Pfeffer & Salancik, 1978). INEDs are appointed for the HC and SC they have. According to Pfeffer and Salancik (1978), "When an organization appoints an individual to a board, it expects the individual will come to support the organization, will concern himself with its problems, will variably present it to others, and will try to aid it" (p. 163). They suggested that directors (including INEDs) bring four primary benefits/resources to the firms: (a) information in the form of advice and counsel; (b) access to channels of information between the firm and environmental contingencies; (c) access to resources; and (d) legitimacy and reputation. Hillman and Dalziel (2003) referred to these resources as board capital, which consists of board HC and SC. They argued that INEDs' HC and SC in the form of their skills, knowledge, expertise and networking, shape the ability of INEDs to perform their governing and advising functions.

2.6 Research on Independent Directors

This section discusses the existing literature on INEDs from two perspectives: agency theory and HC and SC. Agency theory suggests that monitoring by INEDs can mitigate the agency problems that arise from the separation of ownership and control (Berle & Means, 1932, Fama & Jensen, 1983); while HC and SC scholars argue that INEDs must have sufficient ability in terms of knowledge, skills, experience and networking to enable them to carry out their role effectively (Hillman & Dalziel, 2003; Khanna et al., 2014; Kor & Sundaramurthy, 2009; Tian et al., 2011).

2.6.1 Independent Directors from the Perspective of Agency Theory

Extensive research on INEDs is largely based on the agency theory. The main concern of the agency theory is to resolve problems that can exist in agency relationships due to conflicting goals of principals and agents. Prior studies argued that firm ownership structure influences the nature of this agency conflict, that is, whether the conflict is between shareholders and managers or between controlling and minority shareholders (Claessens et al., 2000; Fama & Jensen, 1983; Jensen & Meckling, 1976). In countries with concentrated ownership structure, the main agency conflict is between controlling owners and minority shareholders. In such environment, minority shareholders have little incentive to monitor the company, making them more vulnerable to expropriation by the controlling shareholders (Claessens et al., 2000).

Prior studies suggested that RPTs provide an opportunity for the controlling shareholders to expropriate wealth from minority shareholders (Abdul Wahab et al., 2011; Dahya et al., 2008; Gordon et al., 2004; Kohlbeck & Mayhew, 2010). Conflict between controlling and minority shareholders, together with inadequate regulations

pertaining to RPTs make the problem of expropriation of minority shareholders even worse. Accordingly, the problem of expropriation of minority shareholders via RPTs becomes a major issue particularly in emerging markets and has caused widespread concern among regulators, investors and academicians. The OECD (2008) identifies RPTs as one of the biggest corporate governance challenges faced by many Asian businesses.

Agency theory postulates that the appointment of outside (or independent) directors who are independent, in contrast to inside directors, is an important monitoring mechanism that can strengthen corporate boards (Petra, 2005). The presence of higher number of INEDs on boards may help align controlling shareholders' interest with minority shareholders' interest and consequently decrease private benefit extraction (Kim, Kitsabunnarat-Chatjuthamard, & Nofsinger, 2007). According to Dahya and McConnell (2009), INEDs can reduce resource diversion by monitoring the terms of RPTs and by ensuring that these dealings are not carried out against the interest of minority shareholders.

Many jurisdictions currently make extensive use of independent board members to review and approve RPTs. Certain countries require the use of internal control committee or the audit committee to approve RPTs, where INEDs are, by and large, members of that committee. In Malaysia for instance, the audit committee is required to review conflict of interest and RPTs and to ensure that the dealings are carried out according to normal commercial terms and not detrimental to the interests of the company or its minority shareholders (CGG, 2009). Paragraph 15.09 of the BMLR states that the audit committee shall consist of not fewer than (3) members, all of whom

shall be non-executive directors and the majority shall be INEDs. Persons appointed as INEDs must satisfy the definition of INED set out in Paragraph 1.01 and Practice Note 13 of the BMLR. As discussed in Section 2.5.1, the BMLR set out seven criteria for an INED. In summary, a director needs to be independent of management and should be free of any business or other relationship which could interfere with the exercise of independent judgement or the ability to act in the best interests of the company (Corporate Governance Blueprint [CGB], 2011).

The importance of INEDs in monitoring RPTs is also recognized by the OECD. The OECD addresses the role of INEDs in monitoring and managing potential conflict of interest of management, board of directors and shareholders (OECD, 2008). With regards to RPTs, the OECD (2009) recommended that INEDs should play a vital role in monitoring RPTs, such as designing board approval procedures, conducting investigations and having the possibility for obtaining advice from independent experts.

Many studies have been conducted to examine whether INEDs can play a role in monitoring RPTs; however, international evidence on this topic is inconclusive. Some studies reported that the presence of higher number of INEDs on the corporate board can mitigate the negative effect of RPTs (e.g., Cheung et al., 2009; Dahya et al., 2008; Gallery et al., 2008; Lo, Wong, & Firth Lo, 2010), while others fail to support such view (Arshad et al., 2009; Cheung et al., 2006; Khosa, 2017). In these studies, INEDs were measured based on the number or the percentage of INEDs on the boards.

Dahya et al. (2008) investigated the roles of INEDs in constraining resource diversion by controlling shareholders across 22 countries. They found a significant negative relationship between the proportion of INEDs and the occurrence of RPTs, and the relationship between firm value and RPTs. The findings indicate that firms with more INEDs are linked to less likelihood of diverting firms' resources by controlling shareholders. Thus, the proportion of INEDs strengthens corporate boards and it is more valuable in countries with weak legal shareholder protection.

Using a sample of 266 companies listed on the Shanghai stock exchange, Lo et al. (2010) investigated whether good corporate governance alleviated the opportunistic behaviors of management. They argued that related party sales have a potential to be manipulated by controlling shareholders due to difficulty in monitoring and auditing such transactions. The results show that firms with a higher percentage of INEDs, who are representative of the parent, are less likely to manage earnings through transfer pricing manipulations. The findings indicate that good quality of the board of directors play a significant role in constraining management's opportunistic behaviors.

There are few studies such as Abdul Wahab et al. (2011), Chien and Hsu (2010) and Utama and Utama (2014) that examined the moderating effect of the proportion of INEDs on the relationship between RPTs and firm's outcome. These research suggest that having higher number or higher percentage of INEDs on the board can significantly moderate the relationship between RPTs and firm's outcome suggesting that INEDs can reduce opportunistic behavior of controlling insiders and hence reduce the negative impact of RPTs on firm's outcome. Chien and Hsu (2010) suggested that good corporate governance mechanisms (including the proportion of INEDs) can

transfer RPTs from “conflict of interest” to “efficient transaction”. Similarly, Utama and Utama (2014) suggested that the proportion of INEDs reduces the likelihood of abusive RPTs and accordingly, most RPTs are conducted for efficiency purposes.

On the other hand, some studies show that INEDs are less effective in monitoring RPTs. For example, Khosa (2017) provided evidence that INEDs are ineffective in monitoring controlling shareholders and, thus, valued negatively by the market. Khosa (2017) argued that the dominance of controlling families on the board makes the INEDs ineffective in monitoring RPTs. The reasons why INEDs are less likely to be used as corporate monitor by family firms are: (a) they pose a challenge to family owners in terms of perceived loss of control; (b) they have little influence on issues involving family members; (c) they are appointed by controlling shareholders and this may compromise their independence, and (d) they hardly attain the status of blockholder in family firms, and therefore less motivated to be actively involved in the management of the firm. Cheung et al. (2006) found that INEDs have no monitoring effect on tunneling behavior by controlling shareholders in China. Study by Arshad et al. (2009) did not find any association between the extent of RPTs and INEDs, suggesting that INEDs do not add value to a firm in terms of increasing the level of RPTs disclosure.

2.6.2 Independent Directors from the Perspective of Human Capital and Social Capital

INEDs are assumed to bring valuable resources to the firms which include a diverse range of skill, experience, knowledge and networking (Carpenter & Westphal, 2001; Hillman & Dalziel, 2003; Kang, Kim, & Lu, 2017; Muttakin, Khan, & Mihret, 2016;

Tian et al., 2011). Hillman and Dalziel (2003) referred to these resources as board capital, consisting of both HC and SC. The capital resides at the individual (i.e. human capital) and relational (i.e. social capital) levels. Burt (1997) argued that HC is a quality of individuals, whereas SC is a quality created between people. According to Johnson et al. (2013), director's HC can range from industry familiarity, experience as CEO, experience in finance or venture capital, experience with specific activities such as firing a CEO, to overall familiarity with the firm. HC gives impact to board's activities as director's experience and knowledge affect his/her cognitions and decisions. For director's SC, it can be classified into three types: ties to other firms, personal relationships and affiliations with firm managers, or social standing (Johnson et al., 2013). SC is argued to influence the advisory and counsel role of directors (Carpenter & Westphal, 2001; Westphal, 1999) and affect their decision-making process (Oh, Labianca, & Chung, 2006).

Board capital scholars argue that while INEDs have the incentives to monitor management and controlling shareholders, those with higher HC and SC may perform their roles more effectively (Hillman & Dalziel, 2003; Muttakin et al., 2016; Tian et al., 2011). Proponents of board capital contend that INEDs are not homogenous in terms of skill and knowledge and ignoring these aspects may result in incomplete understanding on the influence of INEDs on firm's outcome. According to Hillman and Dalziel (2003), the ability of INEDs to perform their monitoring as well as their resource provision roles is a function of their HC and SC. Having a board composed of highly skilled and knowledgeable INEDs can reduce the problem of excessive CEO influence on the board (Stevenson & Radin, 2009) and generate substantial value for

firms such as competitive advantage, firm performance and innovation (Chen et al., 2017; Guldiken & Davendeli, 2016; Kim, 2007; Nahapiet & Ghoshal, 1998)

The concept of directors' HC and SC has gained prominence in recent years. Some of the emerging studies on board of directors investigated the link between directors' HC and SC on firm value (Khanna et al., 2013; Kim, 2007; Kim & Lim, 2010), firm's internalization decision (Chen et al., 2017), R&D decision (Guldiken & Davendeli, 2016), CEO selection (Tian et al., 2011), acquisition performance (Field & Mkrtchyan, 2017), and environmental performance (de Villiers et al., 2011). Resource dependence, human capital and social capital theories are among the dominant theories used in those studies. Since HC and SC are multidimensional concept, different constructs are employed to capture that capital. Drawing from prior literature, this study focuses on three constructs of INEDs' HC and SC namely functional knowledge in accounting, firm-specific knowledge and external social ties (or external networking).

2.6.2.1 Functional Knowledge in Accounting and Finance

Functional knowledge refers to information acquired from the traditional domains of business such as accounting, finance, and marketing (Forbes & Milliken, 1999). There is evidence that the appropriate expertise of board members increase firm's outcome (de Villiers et al., 2011; Hillman & Dalziel, 2003; Kroll et al., 2008). For example, de Villiers et al. (2011) documented that a director with legal background has a better understanding of the legal environment, and therefore is more likely to understand, monitor, and pursue issues relating to the environment.

Following a number of accounting scandals in the early 2000s, the need for more board members to be knowledgeable in accounting and finance has received much attention from regulators. For instance, the Sarbanes Oxley Act (SOX) of 2002 requires all companies listed on the US stock markets to have audit committee consisting entirely of INEDs and has at least one member with financial expertise. While definitions of financial expertise are broad, the SOX specifies that a person must have the following attributes to qualify as a financial expert: (a) an understanding of generally accepted accounting principles (GAAP) and financial statements; (b) the ability to assess the general application of GAAP in connection with the accounting for estimates, accruals and reserves; (c) experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities; (d) an understanding of internal control over financial reporting; and (e) an understanding of audit committee functions.

The implicit assumption of the need for more financial experts on the board is that board members with knowledge in accounting or finance will lead to effective functioning of board monitoring (Guner, Malmendier, & Tate, 2008), such as detecting problems in financial reporting (Agrawal & Chadha, 2005), and hence will better serve the interest of shareholders (Guner et al., 2008). Being members of the audit committee, it is vital for INEDs to be equipped with such knowledge due to their numerous responsibility that requires a relatively high degree of accounting sophistication (Defond, Hann, & Hu, 2005). Razman and Mohd Iskandar (2004)

suggested that audit committee members who have accounting, auditing or finance knowledge are better able to meet their responsibilities of monitoring internal control and financial reporting. Study by Defond et al. (2005) provided evidence that market reacts positively to the appointment of accounting financial experts to the audit committee, suggesting that INEDs with accounting knowledge improve the audit committee's ability to ensure high quality of financial information.

Prior studies suggested that the presence of higher number of INEDs with financial knowledge may enhance the quality of financial reporting process. For example, they are found to reduce the likelihood of fraud and earnings restatements (Abbott, Parker, & Peters, 2004; Agrawal & Chadha, 2005), to be more effective in mitigating earnings management (Carcello, Hollingsworth, Klein, & Neil, 2006; Xie, Davidson, & DaDalt, 2003), and less likely to be associated with the occurrence of internal control problems (Hoitash et al., 2009; Krishnan, 2005; Zhang et al., 2007). Study by McMullen, Raghunandan, and Rama (1996) documented that firms with financial reporting problems are unlikely to have financial experts on their audit committees. Other studies directly investigated whether board's financial expertise had a positive impact on a firm's financial reporting quality. For instance, Felo, Krishnamurthy, and Solieri (2003) found a positive relationship between the proportion of financial expertise on the audit committee and financial reporting quality. This finding suggests that having more financial expertise on audit committees rather than simply requiring one expert on the audit committee may be beneficial to investors.

2.6.2.2 Firm-specific Knowledge

Firm-specific knowledge refers to “detailed information about the firm and an intimate understanding of its operations and internal management issues” (Forbes & Milliken, 1999, p. 495). The knowledge is recognised as one of the critical aspects of HC that affects firms and individuals' productive capabilities (Kor & Sundaramurthy, 2009; Mahoney & Kor, 2015; Pfeffer & Salancik 1978). According to Mahoney and Kor (2015), firm-specific knowledge is formed and possessed by individual over time through interactions among a firm's employees, managers, constituents, and physical, technological, and knowledge-based resources.

Mahoney and Kor (2015) identified three components of firm-specific knowledge which include the experiential knowledge of (a) firm's idiosyncratic resources and capabilities; (b) firm's employees' (including managers') strengths, limitations, and idiosyncratic habits, which affect team outcome and collaboration; and (3) firm's key constituents and stakeholders including their specific contributions, needs, and interactions with firm. The efficient exploitation of such knowledge can be a source of new ideas and innovation (Dost, Badir, Ali, & Tariq, 2016), which may lead to firm's success and competitive advantage (Mahoney & Kor, 2015). For example, Dost et al. (2016) suggested that individuals with specialized knowledge of routine resources, firm's capabilities, habits, abilities and limitations would facilitate an environment of cooperation, which in return will have influence on innovation generation.

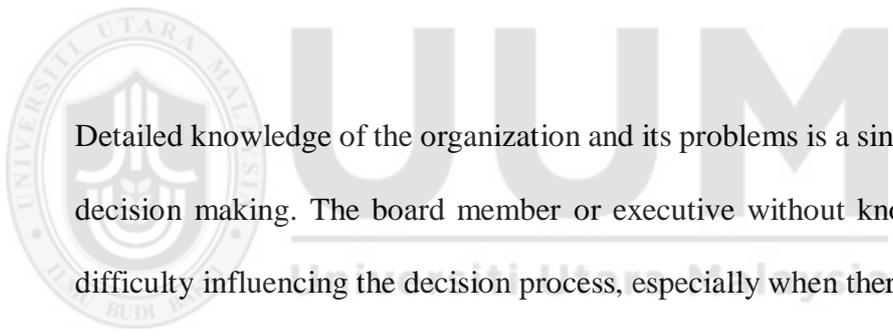
In a boardroom context, resource dependence, human capital and social capital theories postulate that a director with firm-specific knowledge possesses important resources for a firm (Forbes & Milliken, 1999; Hillman & Dalziel, 2003; Pfeffer &

Salancik, 1978). Equipped with firm-specific knowledge allows them to understand the context for their decision making (Mire, 2016). Therefore, knowledge about firm's operations is essential for the effectiveness of the boards to perform their monitoring and advising roles (Hillman & Dalziel, 2003; Kor & Sundaramurthy, 2009; Mire, 2016). Having in-depth knowledge of the firm enables directors to involve actively in decision making process. For example, directors equipped with substantial knowledge of firm's operations can speak a common language (Kor & Sundaramurthy, 2009; Nahapiet & Ghoshal, 1998), resulting in increasing strategy discussion in the board (Barroso-Castro, Villegas-Periñan, & Casillas-Bueno, 2016).

As part-time board members, INEDs appear to be less informed than inside directors (Bhagat & Black, 2002). Therefore, their effectiveness in monitoring and advising tasks is dependent on the information that they receive or possess (Mire, 2016). According to Mire (2016), INEDs may derive firm-specific information from publicly available material, post-appointment work, professional development, informal interactions between corporate employees and directors, contact with corporate executives or external auditors (in relation to board activities, special projects or committee responsibilities) and from external sources such as share price.

Most prior research used the post-appointment work, regularly termed as "director's tenure" as an indicator of director's firm-specific knowledge (de Villiers et al., 2011; Guldiken & Darendeli, 2016; Johnson et al., 2013; Kor & Sundaramurthy, 2009; Tian et al., 2011). The researchers suggested that INEDs serving on boards for longer periods may have greater firm knowledge; thereby, enabling them to provide superior monitoring of the management. In other words, compared with short-tenured board

members, the long-tenured directors who have greater experience, competency and commitment, are more willing to challenge management decisions. In strategic growth, Kor and Sundaramurthy (2009) argued that during service on a particular board, INEDs develop knowledge of the firm's past commitments and unique resources and capabilities that could assist them in considering the viability of growth strategies proposed by management. Similarly, in R&D investments context, as INEDs spend more time serving on boards, they develop more effective information-processing capabilities and have access to better-quality resources (Tian et al., 2011); thereby providing top managers with diverse and valuable perspectives and advices on R&D projects (Dalziel et al., 2011; Guldiken & Darendeli, 2016). Zald (1969) stated that:



Detailed knowledge of the organization and its problems is a sine qua non of decision making. The board member or executive without knowledge has difficulty influencing the decision process, especially when there are agreed upon goals. Knowledge can come from detailed familiarity with the specific organization or from general expertise about a given technical process. (p. 104).

Furthermore, board members who have served the firm for substantial periods of time are argued to possess internal SC (Fischer & Pollock, 2004) in the form of knowledge of each other and of a firm's top management team (Kor & Sundaramurthy, 2009). Knowledge about other members' skills, personalities and habits allows INEDs to function and make decision effectively as a group (Fischer & Pollock, 2004; Kor & Sundaramurthy, 2009; Westphal & Bednar, 2005). Equally important, familiarity

about top management's personalities and professional skills enables INEDs to more accurately interpret the information received from top managers (Kor & Sundaramurthy 2009). This, in turn, reduces information asymmetry between INEDs and top managers (Guldiken & Darendeli, 2016).

In sum, Dou, Sahgal, and Zhang (2015) suggested that long-tenured INEDs are referred as experienced directors that may actually be optimal for firms because: (a) they have experience dealing with multiple CEOs and can therefore better assess the ability of the current CEO; (b) they have significant equity stakes in the firm, which may align their interests with shareholders; and (c) they can provide a balance of power in the boardroom. Their study provided evidence supporting improved governance by long-tenured INEDs. In particular, they found that INEDs with extended tenure are more willing to attend board meetings and also become members of the major board monitoring committees suggesting their higher level of commitment. Moreover, they also documented that firms with a higher proportion of long-tenured directors have lower CEO pay, higher CEO turnover-performance sensitivity, and lower earnings restatements. These firms also limit the expansion of resources under the CEO's control as they make fewer acquisitions, while the acquisitions that are made are of higher quality.

However, there are some prior research that suggested that long tenure directors are less independent and objective. Consistent with management friendliness hypothesis, they argued that director with long board tenure are more likely to have a friendly relationship with the management, which is built over time (Vafeas, 2003). Their close relationship with the management may lead to the entrenchment that reduces their

monitoring effectiveness. For example, Vafeas (2003) provided evidence that senior directors are more likely to make decisions favoring the management. Vafeas also discovered that CEOs tend to receive higher levels of compensation when compensation committees are made up of senior directors. Rickling (2014) found that audit committee director tenure is positively associated with the likelihood of a firm repeatedly holding meetings or just beating analysts' forecasts.

In addition, the US Senate report on Enron (The US Senate, 2002) discovered that the board tenure is another flaw in corporate governance practices. The report documented that some of the Enron's directors had served on the board for at least 10 years. The findings suggest that long-tenured directors are more likely to develop some sort of relationship with the management and thus, less likely to monitor the management. Since then, the topic of board tenure has garnered much international attention and the debate largely centers on whether term limits policy for directors ought to be enforced. More recent trends show a growing number of companies adopting tenure-related guidelines for INEDs. For example, Hong Kong, Malaysia, Singapore, South Africa and United Kingdom (UK) recommend a maximum tenure of 9 years for INEDs. In Malaysia and the UK, directors with more than 9 years tenures are deemed non-independent unless the company can explain otherwise.

2.6.2.3 External Networking (or Social Ties)

INEDs' external networking or external social ties refers to the level of their external interconnectedness which includes actual or potential ties to external organizations and other contingencies (Hillman & Dalziel, 2003; Kim, 2007; Melkumov & Khoreva, 2015). From the perspective of resource dependence theory, INEDs' external

networking can link or bridge the firm to the external environment. The linkages can be in the form of ties to the firm in which they have full-time employment, seats on the board of other firms, personal relationships, affiliations, and social standing such as status, prestige, stigma, and reputation (Johnson et al., 2013; Kim, 2007).

From SC perspective, there are valuable resources embedded within, available through, and derived from such networking relationships possessed by each director (Hillman & Dalziel, 2003). The networking relationships and the resources attached to these relationships are referred as SC. The ability of INEDs to access such resources through their external networking can benefit the individual directors as well as the hiring firm (Barroso-Castro et al., 2015; Kim, 2007; Kor & Sundaramurthy, 2009; Valenti & Horner, 2010; Zona, Gomez-Mejia, & Withers, 2015). Highly connected INEDs are argued to bring valuable resources to the hiring firm such as exposure to information and knowledge in the external environment, which in turn will increase the successful implementation of firm's strategies (Kor & Sundaramurthy, 2009). For individual directors, external SC offers a director with personal contacts that can be critical to his/her career advancement (Mizruchi, 1996).

There are at least three benefits that firms could gain from directors' external networking. First, such external ties can serve as a boundary spanner, providing channels for communication information between the firm and its external environment (Barroso-Castro et al., 2015; Carpenter & Westphal, 2001; Hillman et al., 2000; Pfeffer & Salancik 1978; Zahra & Pearce 1989). For example, directors having ties with strategically related firms have been found to provide better strategic

guidelines, which is positively related to firm performance (Westphal, 1999; Carpenter & Westphal, 2001).

Second, better-connected (or better-networked) INEDs can act as a cooperative device for a firm to extract resources and gain support from influential agents or external stakeholders that may be critical to the firm performance (Barroso-Castro et al., 2015; Hillman et al., 2000; Kiel & Nicholson, 2006; Zahra & Pearce, 1989). For example, community influential directors (which include directors with knowledge about or influence over important non-business organizations) can provide valuable non-business perspectives on proposed actions and strategies and can therefore help the firm in gaining commitments or support from social constituents (Hillman, Cannella, & Paetzold, 2000).

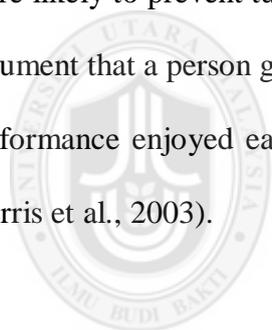
Third, the presence of highly connected INEDs can play a significant role in enhancing firm legitimacy (Pfeffer & Salancik 1978; Zahra & Pearce 1989). By appointing well-connected directors such as directors with prestigious status to its board, the firm is signaling to investors, creditors and other key stakeholders such as suppliers and customers, of the value and worth of the firm (Hillman et al., 2000; Oehmichen, Braun, Wolff, & Yoshikawa, 2017; Pfeffer & Salancik, 1978). Therefore, legitimacy gained from well-connected directors has a potential to contribute to the success of the firm in capital and factor markets and thus has a positive effect on firm performance (Oehmichen et al., 2017).

Resources or benefits arising from those networks are essential for firm's competitive advantage and success (Kim, 2005). Due to its importance for the firms, external

networking appears to be one of the attributes that is considered in the appointment of board members as this networking is argued to help the firm in attracting critical resources, enhancing firm's reputation and thus ensuring improved performance (Barroso-Castro et al., 2015; Kim & Cannella, 2008).

One of the major sources of director's external social ties is via multiple board appointments (Hillman & Dalziel, 2003; Mizruchi, 1996). Directors (including INEDs) who serve on multiple boards tend to have greater SC because they have better access to a variety of key resources such as strategic information, learning from other directors' or firms' experiences and legitimacy (Barroso-Castro et al., 2015; Omer, Shelley, & Tice, 2014). The information and experience can be transferred and shared between board members, which in turn could influence board decision making (Chen, Wang, & Lin, 2014; Omer et al., 2014). Firms can benefit from SC established through outside directorships as the capital can affect the effectiveness of INEDs in their role as corporate monitors and advisors (Barroso-Castro et al., 2015; Kor & Sundaramurthy, 2009; Omer et al., 2014; Tian et al., 2011; Valenti & Horner, 2010; de Villiers et al., 2011). For example, McNulty and Pettigrew (1999) explained that in firm's strategic decision process, INEDs involved as: "taking of decisions", "shaping of decisions" and "shaping of the content, context and conduct of strategy". Therefore, their expertise and knowledge gained from networking with other board members may provide fresh perspective and new idea on strategic proposals. Benefits arising from external directorships are complex and difficult to replicate, and therefore they constitute an important competitive resource (Barroso-Castro et al., 2015).

The arguments put forward by the resource dependence, human capital and social capital theories regarding the importance of INEDs' external SC gained through multiple directorships are in line with the "director quality" and "director reputation" hypotheses. Fama and Jensen (1983) and Vafeas (1999) contended that the number of directorships held by a director might be a signal for reputational capital, with such person being perceived as a high quality director, and therefore increasing the probability of securing additional board seats in the future (Chen et al., 2014). As a result, the reputation status can be an important incentive for the directors to provide high quality of monitoring and advising of management (Fama & Jensen, 1983). Chen et al. (2014) suggested that INEDs that are concerned with their reputation status are more likely to prevent tunneling by controlling shareholders. Furthermore, there is an argument that a person gets elected onto numerous boards is being due to the superior performance enjoyed earlier by the firm for which that person serves as a director (Ferris et al., 2003).



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Prior research found that directors who serve on multiple boards are more effective monitors and advisors, resulting in positive economic consequences for the firm (Ferris et al., 2003; Kor & Sundaramurthy, 2009; Omer et al., 2014; Tian et al., 2011). For example, Omer et al. (2014) provided evidence that well-networked directors have a positive impact on firm value and the impact is greater for outside (independent) directors. The results suggest that the directors' cost of acquiring external information can be offset by the potential benefits of greater and faster access to information from other firms. Study by Kor and Sundaramurthy (2009) showed that INEDs' external SC is associated with higher rates of sales growth in the US high-technology firms. The results suggest that INEDs' external networking not only serve as a conduit for

information and other critical resources, but also can expose them to a diverse set of strategic and governance issues, which in turn contributes to the group's general HC. Using a sample of 208 new CEO appointment events in the US manufacturing firms between 1999 and 2003, Tian et al. (2011) found a positive relationship between independent board members' external directorship ties and investor reactions to a new CEO selection. The result reveals that the ability of INEDs in the form of external social networking is valued by capital market and is considered to be critical determinant of INEDs' task performance.

However, there are some prior studies that showed that INEDs' directorships reduce monitoring effectiveness, and consequently this attribute has been used as a proxy for the "busyness" of INEDs in corporate governance research (Core, Holthausen, & Larcker, 1999; Ferris et al., 2003; Fich & Shivdasani, 2006). Multiple board appointments raise questions about the independence and quality of board decisions making because serving on many boards require directors' commitment of time and attention (Carpenter & Westphal, 2001). Overcommitted directors might shirk their responsibilities as corporate monitors and advisors, resulting in severe agency problem (Ferris et al., 2003). Fich and Shivdasani (2006) found that firms with a higher percentage of outside directors serving on three or more other boards experience significantly lower market-to-book ratios, less profitability, and lower chief executive officer (CEO) turnover sensitivity to firm performance. Core et al. (1999) found that busy outside directors provide CEOs with higher compensation packages, which in turn reduce firm performance. Devos, Prevost, and Puthenpurackal (2009) found an inverse relation between the number of outside board seats and investors reaction

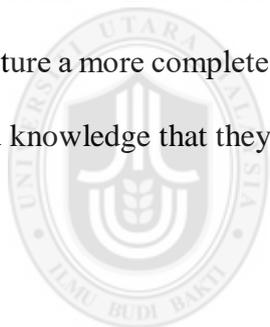
suggesting that multiple directorships have a potential to increase managerial entrenchment at the expense of shareholders.

2.7 Conclusion

In summary, the existing literature suggests two different perspectives on the nature and effect of RPTs. First, from the perspective of conflict of interest, RPTs are considered as a way of expropriating firm's resources and therefore these transactions are viewed as harmful to the interests of shareholders. Second, from the perspective of efficient transaction, RPTs can be part of efficient contracting arrangements with related parties particularly in situations with incomplete information. Even though findings tend to provide support for the conflict of interest perspective, there is evidence that not all RPTs have negative effects attached to them. In particular, prior studies highlighted that the adverse effects of RPTS are affected by the types of RPTs as well as the types of related parties. Furthermore, the negative effects of RPTs can be mitigated to a certain degree by stronger governance.

The topic of RPTs is relatively less researched in Malaysia. Most prior studies are carried out in developed countries and China. Findings from these studies may be different from Malaysia due to differences in corporate governance practice, ownership structure, legal, regulatory and institutional environments, as well as historical and cultural factors. For example, companies in developing countries like Malaysia tend to have concentrated ownership. In this setting, the main agency conflict is between controlling shareholders and minority shareholders. Hence, differences in agency problems may lead to different types of RPTs.

The existing literature suggests that INEDs can balance and limit the strong power and incentives of the insiders, thereby effectively reducing their opportunistic behavior. Many studies have been conducted to understand the governance role of INEDs in monitoring management and controlling shareholders' activities including transactions with related parties. These studies, however, yielded inconclusive results. Some studies documented that a higher percentage of INEDs lessens the negative impact of RPTs on firm's outcomes, while others fail to provide such evidence. The inconclusive results may be due to prior studies treating INEDs as homogenous, and therefore overlooking their heterogeneous ability in terms of their knowledge, experience and networking. Therefore, as suggested by board capital scholars, it is important to include board's HC and SC in addition to board independence in order to capture a more complete view of the breadth and depth of directors' skills, experiences and knowledge that they bring to the boards.



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CHAPTER THREE

THEORETICAL FRAMEWORK AND HYPOTHESES DEVELOPMENT

3.1 Introduction

This chapter has four sections and the first section explains about the theoretical background of this study. The second section discusses the conceptual framework underpinning this study, whereas the third section presents the hypotheses to be tested. Hypothesis 1 tests the relationship between RPTs and firm performance. Furthermore, Hypothesis 2 tests the moderating effect of the proportion of INEDs on RPTs-firm performance relationship. Hypotheses 3, 4, and 5 test the moderating effects of INEDs' HC and SC (i.e. functional knowledge in accounting and finance, firm-specific knowledge, and external networking, respectively) on RPTs-firm performance relationship. Finally, the fourth section concludes the chapter's main theme.

3.2 Theoretical Background of the Study

According to Hillman and Dalziel (2003), the boards (including INEDs) have two main functions, namely as corporate monitor (prescribed by the agency theory) and resource provider (prescribed by the resource dependence theory). From the agency viewpoint, INEDs who are independent of the management and care about their reputation are more vigilant to monitor managers and controlling shareholders on behalf of shareholders (Fama, 1980; Fama & Jensen, 1983). In contrast, the resource dependence theory suggests that resource-rich INEDs – those with valuable resources in the forms of knowledge, expertise, experience, and networking – have more HC and SC, therefore, they enable the firms to minimise dependence or gain resources (Hillman & Dalziel, 2003; Pfeffer, 1972; Pfeffer & Salancik, 1978).

Hillman and Dalziel (2003) suggested that in order to enhance the agency's perspectives on what INEDs do and how they affect firm's outcomes, it is vital to integrate the agency theory with the resource dependence theory. The suggestion was supported by Kroll et al. (2008) who argued that relying solely on the agency theory is insufficient in explaining the board's effectiveness in corporate decision making and control. Moreover, Kroll et al. advocated the need to examine directors' HC and SC in order to gain greater understanding of the linkage between board of directors and firm's outcomes.

Following the recommendations of Hillman and Dalziel (2003) and Kroll et al. (2008), this study employs the agency and resource dependence theories to provide the theoretical basis for the hypotheses tested. In addition, this study also adopts the human capital and social capital theories as these two theories are closely related to the resource dependence theory. Both human capital and social capital theories focus on the experience, knowledge, and networking that board members bring into the board (Barroso-Castro et al., 2015; Khanna et al., 2013; Tian et al., 2011). These theories suggest that INEDs' HC and SC contribute to the board's effectiveness.

3.2.1 Agency Theory

The agency theory has been used extensively in corporate governance research. Advocates of the agency theory argued that the agency costs can arise either from the conflicts between dispersed shareholders and managers (also known as the principal-agent conflict) or between controlling shareholders and minority shareholders (also known as principal-principal conflict) (Claessens et al., 2000; Dharwadkar, George, & Brandes, 2000; Fama & Jensen, 1983; Jensen & Meckling, 1976; Young et al., 2008).

Figure 3.1 shows the graphic difference between the principal-agent conflict and the principal-principal conflict.

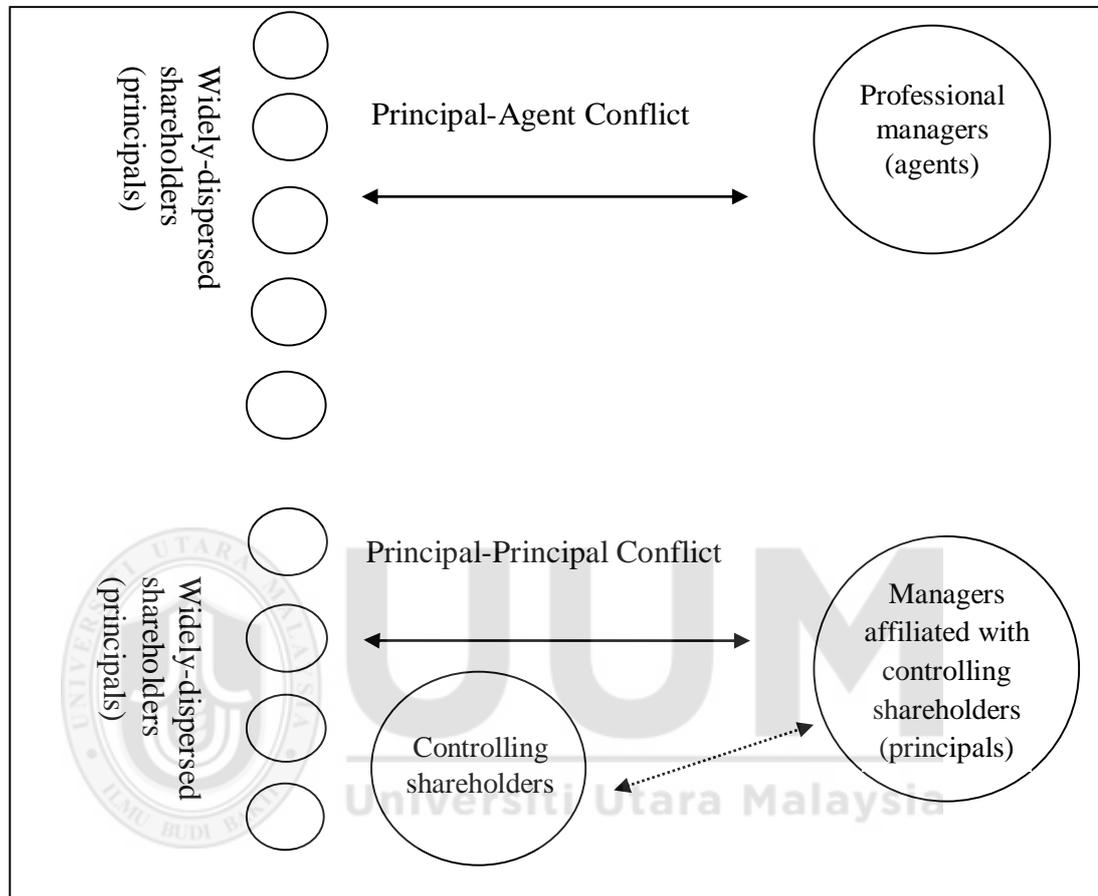


Figure 3.1
Principal-Principal Conflict versus Principal-Agent Conflict
 Source: Young et al., 2008

As shown in the top panel of Figure 3.1, most corporate governance research in countries with dispersed ownership structure were based on the traditional principal-agent conflict. Jensen and Meckling (1976) explained that agency relationship exists when one party (the principal) contracts with another party (the agent) to perform some services on the former's behalf, which involves delegating some decision-making authority to the latter. If all parties to the agency relationship have different interests

and aim to maximise their particular value, there is possibility that the agent will not act in the best interests of the principal.

The traditional principal-agent conflict is based on the premise that managers have more information than shareholders. This information asymmetry adversely affects the ability of the shareholders (owners) to effectively monitor whether their interests are being properly served by the managers. Jensen and Meckling (1976) contended that shareholders could limit divergences from their interest by providing the agent with appropriate incentives and by incurring the monitoring costs that can decrease the agent's value-reducing activities. However, when ownership is widely distributed, it is less desirable for any individual shareholder to incur significant monitoring costs because the benefits associated with monitoring are shared among the shareholders proportionally to their stake (Holderness, 2009; Shleifer & Vishny, 1986).

Thus, the agency theory holds that ownership concentration and closer alignment of ownership and control are considered as the solution to the principal-agent conflict. When ownership is concentrated in one or few hands, it is easier and more efficient for those shareholders to directly monitor managerial behaviour (Hope, 2013). It is expected that agency costs will be lower as ownership concentration increases. While this mechanism may be a viable governance option in large companies in developed economies (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1997), the concentrated ownership may give rise to another form of agency conflict, which is between controlling shareholders and minority shareholders or also known as the principal-principal conflict in the emerging countries.

Consequently, the principal-principal conflict has become a major concern of corporate governance in emerging markets, including Malaysia (Jiang & Peng, 2010; Young et al., 2008). The prevalence of concentrated ownership was claimed to be a root cause of the principal-principal conflict (Young et al., 2008). The conflicts are getting more severe when legal mechanism to protect the minority shareholders against the risk of opportunistic behaviour by the controlling shareholders is relatively absent or ineffective. In this situation, the controlling shareholders can strengthen their power by appointing directors or managers that are affiliated to them.⁷ In turn, this gives the controlling shareholders the opportunity to control management decisions. As a result, the managers are more inclined to concentrate on the interest of the controlling shareholders rather than to maximise the shareholder value in general (Ishak & Napier, 2006).

The bottom panel of Figure 3.1 shows the principal-principal conflict. The relationship between the controlling owners and their affiliated managers is depicted by the dashed arrow, whereas the conflict between the affiliated managers (who represent the controlling owners) and the minority shareholders is depicted by the solid line. Hence, in concentrated ownership structure, the main agency conflict is not between the managers and shareholders, but is between the controlling shareholders and minority shareholders (Jiang & Peng, 2010; Young et al., 2008). However, the realities of principal-principal problems dominating the developing markets are not captured in the traditional agency framework of Jensen and Meckling (Young et al., 2008).

⁷ According to Klein (1998), affiliated directors are former employees, family members, directors with board interlocks, and professionals with significant business or financial ties with the firm

The principal-principal conflict is potentially more severe in emerging markets due to extraordinary concentration of control, extensive business group structures, and ineffective external governance mechanisms in protecting the rights of the minority shareholders (Faccio et al., 2001; Young et al., 2008). In such environment, the minority shareholders have little say in corporate affairs, making them more vulnerable to expropriation by the controlling shareholders (Claessens et al., 2000; Faccio et al., 2001; Mitton, 2002). As a result, the problem of expropriation of minority shareholders has become a major issue, particularly in the emerging markets, and has caused widespread concern in the academic literature.

The occurrences of many corporate scandals revealed that RPTs were used as an expropriation tool by the controlling parties (Munir et al., 2013; Gordon et al., 2004). Basically, RPTs are a common business feature in which they are conducted through subsidiaries, joint ventures, associates, or affiliates. As discussed in Chapter 2.3, there are two alternative views of RPTs, namely the efficient transaction and the conflict of interest transaction. From the perspective of efficient transaction, RPTs can be part of efficient contracting arrangements with related parties (Kohlbeck & Mayhew, 2010) or as a “bonding mechanism” between the related parties (management) and the company (Gordon & Henry, 2005). From the viewpoint of conflict of interest transaction, RPTs represent potential conflict of interest between the insiders (the management and controlling shareholders) and the minority shareholders. Thus, they are viewed as harmful to the interest of the minority shareholders (Gordon et al., 2004).

One of the main concerns relating to RPTs is a mechanism that can curb the controlling shareholders from engaging in abusive or harmful RPTs. The problem is particularly

severe in emerging countries where corporate governance mechanisms such as dispersed ownership structures, active external takeover markets, and high-quality disclosure are less effective in protecting the minority shareholders (Liu & Lu, 2007). Previous studies found that expropriation via RPTs are more likely to occur when firms' corporate governance mechanisms to reduce the probability of opportunistic behaviour by the managers and controlling shareholders are weak (Abdul Wahab et al., 2011; Gordon et al., 2004; Kohlbeck & Mayhew, 2004). Kohlbeck and Mayhew (2010) contended that good quality corporate governance can play a role to monitor RPTs and hence, can reduce the agency costs associated with the deals.

As explained by Dharwadkar et al. (2000), the traditional agency solutions used in developed countries like U.S. may not fit for emerging economies due to different agency problems. Therefore, a different bundle of corporate governance practices is needed to mitigate the severity of the principal-principal conflict. However, corporate governance practices vary across countries due to variation in countries' legal, regulatory, and institutional environments, as well as historical and cultural factors. After the 1997/1998 Asian financial crisis and the widespread of accounting scandals involving prominent companies, great reliance has been placed on INEDs as a potential mechanism to monitor abusive RPTs. Due to their supposed independence and objectivity, INEDs are expected to promote good corporate governance and hence, mitigate the risk of minority expropriation. Since then, the concept of board independence has become a priority in many corporate governance reforms.

3.2.2 Resource Dependence Theory

The resource dependence theory was first developed by Pfeffer (1972). The theory emphasises the relationship between a firm and its external environment. Firms are not autonomous and therefore, need to exchange and acquire resources from other firms for survival, as well as for their success. The firms' dependence on scarce resources is characterised in this theory of resource dependence (Pfeffer & Salancik, 2003). Few key insights of this theory are that a firm is an open system that is closely connected to its surrounding environment, and that a firm continually acts to reduce environmental uncertainty and dependence (Hillman et al., 2009; Pfeffer & Salancik, 1978).

Pfeffer and Salancik (1978) proposed five strategies on how firms can reduce environmental dependence: (i) merger and acquisition; (ii) joint venture and other intercompany relationships; (iii) board of directors; (iv) political action; and (v) executive succession. The fundamental aspect of these strategies is “the concept of power”, which refers to control over critical resources (Ulrich & Barney, 1984). Firms are assumed to alter their dependence relationships with other organisations by reducing others' power over them or by increasing their own power over others (Hillman et al., 2009).

The resource dependence theory has a great influence on the research of boards of directors (Hillman et al., 2009). Notably, empirical evidence suggests that the resource dependence theory is a more successful theoretical lens for understanding boards of directors compared to other relevant theories (Hillman et al., 2009). The theory describes the boards, particularly INEDs, as “boundary spanners”, spanning the

boundary between the firm and its environment (Daily, Dalton, & Camella, 2003; Hillman et al., 2009; Zahra & Pierce, 1989). Thus, from the perspective of the resource dependence theory, INEDs are not only viewed as the means to monitor managerial behaviours as suggested by the agency theory, but also to provide critical resources to the firm (Hillman et al., 2003, 2009; Pfeffer, 1972; Pferrer & Salancik, 1978).

There are four types of resource that INEDs can provide to the firm: (i) information in the forms of advice and counsel; (ii) access to channels of communication between the firm and external entities; (iii) preference access to resources; and (iv) legitimacy. According to Hillman and Dalziel (2003), in order to fulfil the resource provision role, INEDs must have sufficient ability. This ability refers to the board's capital which consists of HC and SC (or networking) that members of the board bring into the firm (Hillman & Dalziel, 2003; Kor & Sundaramurthy, 2009; Khanna et al., 2011).

Hillman and Dalziel (2003) proposed a theoretical model that combines the perspectives of the agency theory and the resource dependence theory. They argued that the HC and SC of the members of the board positively influence both functions of the board as corporate monitors and resource providers. HC and SC are closely related to the resource dependence theory, but both are derived from different theoretical viewpoint (Coleman, 1990). The concept of HC is rooted in the economic literature and is often applied in labour economics (Becker, 1964), while the concept of SC originates from sociology (Coleman, 1990). Both HC and SC theories are discussed in the following sections.

3.2.3 Board Capital Perspective

As discussed in Section 3.2.1, the agency theory posits that INEDs, because of their independence, have more incentive than the internal directors to monitor the managers and controlling shareholders (Fama & Jensen, 1983). Therefore, the presence of higher number of INEDs in the boardroom seems to increase board's effectiveness. Scholars that premised their research on the agency theory treated INEDs as a homogenous group and ignored the heterogeneity in their ability in terms of knowledge and skills to monitor the managers and controlling shareholders. The theoretical perspectives on board capital emerged due to the limitations of the agency theory. Proponents of the board capital perspective argued that for the board to perform their role effectively, they must have sufficient ability in the forms of their HC and SC (Hillman & Dalziel, 2003; Tian et al., 2011).

3.2.3.1 Human Capital Theory

HC refers to the resources that are embedded within individuals (Becker, 1962). These resources consist of knowledge, skills, expertise, experience, and reputation developed through investments in education, training, and various experiences (Becker, 1962; Hillman & Dalziel, 2003). A broader definition is provided by the OECD (2001), where the term HC is described as “the knowledge, skills, competencies, and attributes embodied in individuals that facilitate the creation of personal, social, and economic well-being” (p. 18). Becker (1962), who was among the first to apply the concept of HC, stressed the importance of HC investments through on-the-job training, education, and health in improving the employees' level of knowledge and skills.

Prior research focused mainly on employees' HC as a key element in increasing productivity and sustaining the firm's competitive advantage. As argued by Khanna et al. (2014), directors' HC can also be a source of competitive advantage as their prior experience and education will contribute to the ability of the directors to perform their monitoring and advisory roles. Only recently, the human capital theory started to receive attention in the literature on board of directors (Hillman & Dalziel, 2003; Khanna et al., 2014). By integrating a board's HC with a board's independence, researchers can capture a more complete view of the breadth and depth of the skills, experiences, and knowledge that the directors bring to the board (Dalziel, Gentry, & Bowerman, 2011; Melkumov & Khoreva, 2015).

The benefits associated with the directors' HC had been recognised by a number of scholars. For example, board members with knowledge in accounting or finance can detect problems in financial reporting (Agrawal & Chadha, 2005), mitigate earnings management (Carcello et al., 2006; Xie et al., 2003), and enhance the quality of financial reporting process. This suggests that they will serve the interests of the shareholders better (Guner et al., 2007). In addition, directors with firm-specific knowledge may be better able to understand the context for their decision making (Mire, 2016) and to be actively involved in the decision-making process. This will lead to increased strategy discussion in the boardroom (Barroso-Castro et al., 2015).

3.2.3.2 Social Capital Theory

Social capital (SC) refers to the importance of the individual's resources that are available through his or her social networking with others. According to Nahapiet and Ghoshal (1998), SC is "The sum of actual and potential resources embedded within,

available through, and derived from the network relationships possessed by an individual or social unit” (p. 243). These social resources comprise “wealth, status, power, as well as social ties to those persons who are directly or indirectly linked to the individual” (Lin, Vaughn, & Ensel, 1981, p. 395). Apart from that, Adler and Kwon (2002) referred to SC as the “goodwill that is engendered by the fabric of social relations and that can be mobilised to facilitate action” (p. 17).

The social capital theory proposes that networks of relationships are a valuable resource and therefore, people with rich SC in the sense of their networking with others can perform better than those without such resources (Bourdieu, 1986). Adler and Kwon (2002) summarised that SC, among other things, (i) can influence career success; (ii) helps workers to find jobs; (iii) facilitates the exchange of resources between units; (iv) encourages product innovation; (v) reduces turnover rates; and (vi) strengthen relationship with suppliers.

In the board’s context, SC focuses on the board members’ internal and external networking (Kim & Cannella, 2008; Tian et al., 2011). At the board level, internal social networking is created through board members’ experience of working and interacting with each other (Tian et al., 2011). This co-working experience allows members of the board of director to develop a collectively-owned “bonding” form of SC (Adler & Kwon, 2002). Tian et al. (2011) argued that directors’ internal networking contributes to the ability benefits and opportunity advantages of the board.

In terms of the ability benefits, directors’ experience of working together will develop their tacit firm-specific knowledge. Directors with adequate firm-specific knowledge

may be better able to process the information received and to interpret its meaning within the context of the firm (Tian et al., 2011). Board co-working experience also provides board members with group-specific knowledge in the form of opportunities to share and coordinate their expertise and knowledge (Tian et al., 2011). This in turn will develop the understanding and familiarity of each other's skills, limitations, and idiosyncratic habits (Kor, 2006). In sum, directors with firm-specific knowledge and group-specific knowledge are able to focus better when discussing substantive issues and problems, rather than spending more time to search for information (Tian et al., 2011).

External SC refers to the level of director's external interconnectedness, which includes actual or potential ties to external organisations and other contingencies (Hillman & Dalziel, 2003; Kim, 2007; Melkumov & Khoreva, 2015). Directors with external SC can link or bridge the firm to its external environment. The linkages can be in the form of ties to other firm in which the directors have (i) full-time employment; (ii) seats on the board; (iii) personal relationships; (iv) affiliations; and (v) social standing such as status, prestige, stigma, and reputation (Johnson et al., 2013; Kim, 2005, 2007).

Director's external SC can provide at least three benefits to the firm. First, it acts as a boundary spanner, providing channels for communication of information between the firm and its external environment (Barroso-Castro et al., 2015; Carpenter & Westphal, 2001; Hillman et al., 2000; Pfeffer & Salancik, 1978; Zahra & Pearce, 1989). Second, it serves as a cooperative device for a firm to extract resources and gain support from influential agents or external stakeholders that may be critical to the firm performance

(Barroso-Castro et al., 2015; Hillman et al., 2000; Kiel & Nicholson, 2006; Zahra & Pearce, 1989). Third, it enhances the firm's legitimacy (Pfeffer & Salancik, 1978; Zahra & Pearce, 1989).

3.3 Conceptual Framework

Referring to the framework in Figure 3.2, this study examines the relationship between RPTs and firm performance. In this study, RPTs are classified into two main groups. The first group is related entities, which include transactions with subsidiaries, associates, and joint ventures. The second group comprises related persons, which include transactions with directors; major shareholders; persons connected to the directors, major shareholders, or director-related entities. The need to classify and test RPTs based on the types of related parties is consistent with the argument from prior research that different types of related parties impact firm performance differently.

Prior research provided evidence that companies that have poor governance and monitoring systems are more likely to have more and higher RPTs (Gordon et al., 2004; Kohlbeck & Mayhew, 2010). The agency theory suggests that good quality corporate governance can reduce the agency problem by reducing the lack of information between the agent and the principal. In the corporate governance literature, INEDs are recognised as an essential monitoring mechanism to protect the interest of minority shareholders. However, the empirical findings demonstrated inconclusive results (e.g. Ararat et al., 2010; Cheung et al., 2006, 2009; Dahya et al., 2008; Gallery et al., 2008; Khosa, 2017). For instance, Sharpe (2011) argued that the mere presence of INEDs does not provide the board with “the substantive components

that are necessary for successful, informed decision making, and to form the foundation of the board's monitoring role" (p. 1436).

From the perspectives of the resource dependence, human capital, and social capital theories, the critical components for a successful board include the directors' HC and SC. Therefore, by examining INEDs' HC and SC, this study is expected to help fill in the gaps left by the conventional wisdom that "the more independent a board is, the better".

Based on the arguments from the resource dependence, human capital, and social capital theories as discussed in Sections 3.2.2 and 3.2.3, this study extends prior research by including INEDs' HC and SC. In effort to capture the extent in which INEDs' HC and SC moderate the RPTs-firm performance relationship, this study focuses on three constructs of INEDs' HC and SC, namely their functional knowledge in accounting and finance, firm-specific knowledge, and external networking. Particularly, resource-rich INEDs are expected to have more skills, knowledge, expertise, reputation, and networking. Bringing these resources into the board will enable them to provide superior monitoring and advisory on issues and problems relating to RPTs. Therefore, they may be better able to detect and avoid any conflict of interest in RPTs. On the whole, INEDs' HC and SC are anticipated to weaken the negative (and strengthen the positive) effect of RPTs on firm performance.

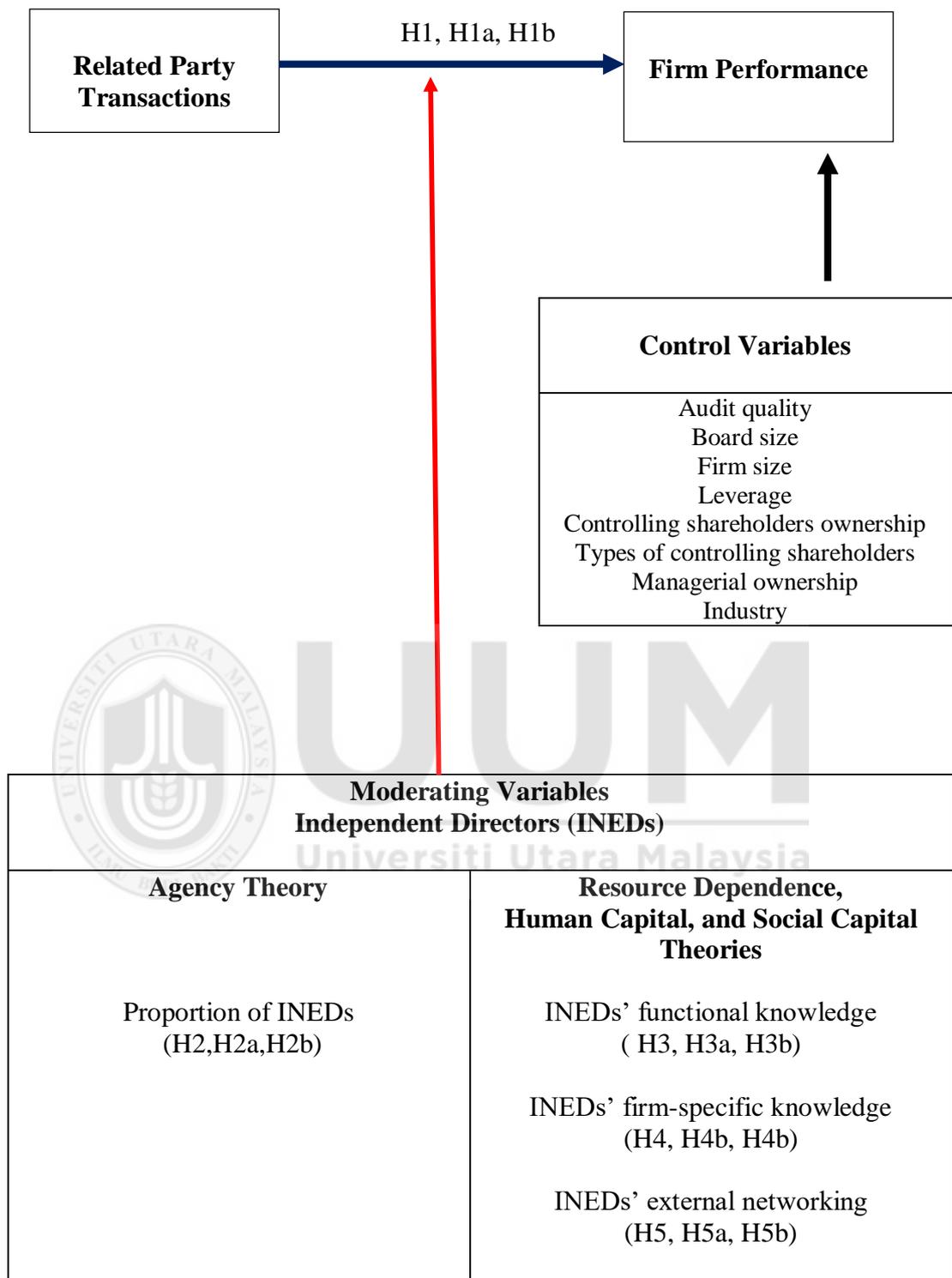


Figure 3.2
Conceptual Framework Underpinning This Study

3.4 Hypotheses Development

3.4.1 Related Party Transactions and Firm Performance

The existing literature suggests that there are both potential costs and benefits related to RPTs. From the perspective of conflict of interest, which is consistent with the agency theory, RPTs are considered as a way of expropriating firm's resources and therefore, these transactions are viewed as harmful to the interests of shareholders (Gordon et al., 2004; Johnson et al., 2000). Generally, parties involved in RPTs are joined by a special relationship prior to the transactions. This special relationship creates potential conflict of interest, which can result in actions that benefit the related parties as opposed to unrelated parties. Thus, RPTs can allow the controlling shareholders to profit at the expense of the minority shareholders, particularly when monitoring mechanisms to reduce the opportunistic behaviour of the insiders are weak or absent (Kohlbeck & Mayhew, 2010).

Expropriation of minority shareholders, or sometimes termed “tunneling” (Johnson et al., 2000) or “self-dealing” phenomenon (Djankov et al., 2008), can take many forms. These include (i) executive perquisites, (ii) excessive compensation, (iii) advantageous transfer pricing, (iv) directed equity issuance, (v) loans at preferential terms, and (vi) outright theft of corporate assets (Faccio et al., 2001; Johnson et al., 2000; Shleifer & Vishny, 1997). In addition, anecdotal evidence like Enron revealed the use of RPTs with special purpose entities by its chief financial officer (CFO) to camouflage debts and create fabricated earnings (Kohlbeck & Mayhew, 2010). The involvement of managers or controlling shareholders in RPTs gives them an incentive to take actions that are not in line with the shareholders’ wealth maximisation (Fama & Jensen, 1983; Jensen & Meckling, 1976).

A number of previous studies had reported the negative impact of RPTs. RPTs had been proven to (i) reduce earnings quality (Gordon & Henry, 2005; Jian & Wong, 2003; Wang & Yuan, 2012); (ii) undermine corporate value (Cheung et al., 2006; Gordon et al., 2004); (iii) lead to loss of business opportunity (OECD, 2009); (iv) contribute to corporate collapse (CFA Institute, 2009); and (v) reduce investor's confidence (CFA Institute, 2009). In sum, the conflict of interest hypothesis postulates that RPTs represent potential conflict of interest, which may result in the expropriation of minority shareholders, and accordingly, RPTs may have a negative effect on firm performance.

In contrast, the efficient transaction's hypothesis suggests that RPTs can be part of efficient contracting arrangements with related parties, particularly in situations with incomplete information (Ryngaert & Thomas, 2012). Ryngaert and Thomas (2012) argued that contracts with related parties provide better coordination and feedback among the contracting parties. RPTs may also mitigate holdup problems in the contracting process and facilitate investment in firm-specific relationship. Thus, transactions with related parties are viewed as more cost effective and cost efficient to firms compared to transactions with unrelated parties. This view is supported by Gordon and Henry (2005) who argued that RPTs fulfil a firm's economic needs and serve as a bonding mechanism that ties the related parties to the company. Consequently, it reduces the incentives of the managers or controlling shareholders to engage in risk-taking behaviour that might jeopardise the firm or the related party's relationship with the firm.

Nonetheless, empirical evidence supporting that RPTs are beneficial is limited. For example, Khanna and Palepu (2000) found that firms affiliated with business group perform better than non-affiliated firms, suggesting that transactions within business groups could assist affiliated firms in terms of better allocation of resources. Friedman et al. (2003), Peng et al. (2011), and Riyanto and Toolsema (2004) showed that RPTs can be used by the controlling shareholders to prop up financially distressed firm or to save the receiving firm from bankruptcy. Furthermore, Peng et al. (2011) depicted that markets react favourably to the announcement of RPTs when the firm is in financial difficulty. Therefore, from the perspective of efficient transaction's hypothesis, RPTs benefit the shareholders and may have a positive effect on firm's outcomes.

Referring to studies conducted in Malaysia, Abdul Wahab et al. (2011), Hasnan et al. (2016), and Munir et al. (2013) provided evidences that support the conflict of interest perspective. These evidences suggested that in Malaysia, RPTs provide channels for the controlling shareholders to extract corporate resources from the minority shareholders and therefore, negatively affect firm performance. The expropriation of minority shareholders via RPTs in Malaysia is more likely to occur due to the dominant presence of family ownership; nature of capital market that is labelled as a relationship-based economy; and weak enforcement and protection of the minority shareholders (Abdul Wahab et al., 2011; Munir et al., 2013). Consistent with prior research and the conflict of interest view, this study argues that in general, RPTs are likely to have a negative effect on firm performance. Based on the above discussion, this paper posits the following hypothesis:

H1 There is a negative relationship between RPTs and firm performance.

Ryngaert and Thomas (2012) argued that not all RPTs are abusive. RPTs may either be potentially beneficial or potentially harmful to shareholders, depending on the types of RPT or types of parties involved in the RPTs (Gordon et al., 2004; Kohlbeck & Mayhew, 2010; Nekhili & Cherif, 2011). This study extends prior research by distinguishing RPTs according to types of related parties. Consistent with MFRS 124 *Related Party Disclosures*, Chapter 10 of the BMLR, and a study by Nekhili and Cherif (2011), RPTs are classified into two major categories, namely RPTs with related entities and RPTs with related persons. The first category covers transactions involving subsidiaries, associates, and joint ventures. Meanwhile, the second category covers transactions involving directors; major shareholders; and person connected to the director, major shareholders, or director-related entities.

In the literature, transactions involving subsidiaries, associates, and joint ventures are not always conducted to violate the minority shareholders' rights (Khanna & Palepu, 2000; Nekhili & Cherif, 2011). The presence of business group and the informal nature of business relationships are among factors that facilitate RPTs. Several scholars characterised business groups as "paragons" that help firms to overcome market failures, especially in difficult economic and institutional conditions (Khanna & Yafeh, 2007). In particular, intra-group transactions between the group and subsidiaries, associates, or joint ventures were argued to help in reducing transaction costs and overcoming difficulties in enforcing property rights and contracts essential for the firm's production (Chen, Chen, & Chen, 2009; Cheung et al., 2009; Khanna & Palepu, 2000; Kim, 2004). RPTs among member firms also involve less information asymmetry than similar transactions with unrelated party (Kohlbeck & Mayhew,

2010). Furthermore, such dealings are perceived as being inevitable, useful, and recurring in ongoing operations (OECD, 2009).

In contrast, transactions with directors; major shareholders; and person connected to directors, major shareholders, or director-related entities were argued to potentially result in the expropriation of the minority shareholders (Nekhili & Cherif, 2011). These parties have been identified to play a major role in many accounting scandals. For example, former CEO and executive director in Transmile were charged by the court for their role in producing false and misleading financial statements resulting from unusual RPTs created to window dress the group's financial statements (Hamid, Shafie, Othman, Hussin, & Fadzil 2013).

Corporate Governance Guide (CGG) 2013 highlights that transactions with related persons may give rise to conflict of interest when parties involved in these transactions have the ability to influence firm's decision making, which in turn lead to personal gain. Nekhili and Cherif (2011) provided evidence that transactions directly made with related persons negatively affect firm performance. These findings are consistent with the study by Kohlbeck and Mayhew (2010) who discovered that the market assigns lower value to firms engaging in RPTs with their directors, officers, or major shareholders. With the above discussion, this paper posits the following hypotheses:

H1a There is a positive relationship between RPTs with related entities (i.e. transactions with subsidiaries, associates, and joint ventures) and firm performance.

H1b There is a negative relationship between RPTs with related persons (i.e. transactions with directors; substantial shareholders; and person connected to the directors, substantial shareholders, or director-related entities) and firm performance.

3.4.2 Moderating Effect of the Proportion of Independent Directors

As discussed in Section 3.2.1, the agency theory postulates that higher INEDs representation on the corporate boards would reduce agency problems. INEDs, being independent from the influence of the management and controlling shareholders, are expected to effectively monitor controlling insiders and hence, can protect the shareholders against insiders' opportunism (Fama, 1980; Fama & Jensen, 1983). With respect to RPTs, INEDs have a role to review and approve the terms and conditions of RPTs to prevent any abuse (OECD, 2012). As a guardian of the minority shareholders, INEDs are expected to scrutinise and give comment whether the proposed RPT is fair, reasonable, and in the best interest of all shareholders. Accordingly, a board dominated by INEDs may be seen as an effective monitoring mechanism to fight against abusive or illegal RPTs because those directors are expected to have an objective perspective in the best interests of the company.

Numerous studies had been conducted to examine the extent to which INEDs monitor RPTs, however, the findings are inconclusive. Some studies provided evidence that having more INEDs will reduce the expropriation of the minority shareholders through RPTs and hence, increase firm performance. For instance, using data from 22 countries, Dahya et al. (2008) found a significant negative relationship between the proportion of INEDs and RPTs which indicate that firms with a higher percentage of

INEDs are less likely to engage in RPTs. Similar results were found in Australia (Gallery et al., 2008), China (Lo et al., 2010), and Indonesia (Utama & Utama, 2014).

Furthermore, few studies on the moderating effect of INEDs on RPTs-firm performance relationship supported the importance of INEDs. For example, Abdul Wahab et al. (2011) and Chien and Hsu (2010) documented that the monitoring role performed by INEDs could mitigate the negative effect of RPTs on firm performance. Their results suggested that good corporate governance mechanisms could transform RPTs from being a conflict of interest to an efficient transaction, which in turn, increases firm performance.

Conversely, several researchers expressed countering arguments on the role of INEDs as corporate monitor. Kim (2007) and Peng (2004) claimed that INEDs may be appointed due to external institutional pressure and therefore, do not necessarily increase efficiency. In countries with concentrated ownership structure, there is a tendency for the controlling shareholders to exert significant influence on the selection of INEDs (Abdullah, Zainal Abidin, Abu Bakar, & Rahman, 2016). Normally, the candidates for INEDs are those within the personal network of the insiders. This personal network or social tie between the INEDs and the controlling shareholders is argued to impair the independence of INEDs (Abdullah et al., 2016; Lin, 2013) and hence, undermine the ability of INEDs to minimise abusive RPTs (Khosa, 2017). The evidence in a research by Khosa (2017) revealed that due to self-control problem in the family firms in India, INEDs are less likely to be an effective monitor and therefore, their presence is valued negatively by the market.

In sum, prior studies provided mixed results on the monitoring role of INEDs. However, consistent with the argument put forward by the agency theory, this study predicts that the presence of higher number of INEDs on the boards would result in better monitoring of RPTs. Board dominated by INEDs is less constrained in questioning or disagreeing with the management (CGG, 2013) and therefore, can reduce the threat of wealth transfers to the controlling shareholders by restraining RPTs that damage firm performance (Dahya et al., 2008). Furthermore, the more stringent rules, regulations, and guidelines in Malaysia aimed to enhance board independence are believed to further empower INEDs to act as an effective “check and balance” on the management and controlling shareholders. Effective monitoring by INEDs is suggested to result in better allocation of firm’s resources via RPTs and thus, the proportion of INEDs could moderate the effect of RPTs on firm performance. Based on the above discussion, this paper posits the following hypotheses:

- H2 The proportion of INEDs weakens the negative relationship between RPTs and firm performance.

- H2a The proportion of INEDs strengthens the positive relationship between RPTs with related entities and firm performance.

- H2b The proportion of INEDs weakens the negative relationship between RPTs with related persons and firm performance.

3.4.3 Moderating Effects of Independent Directors' Human Capital and Social Capital

Board capital scholars argued that the mere presence of INEDs on the board does not guarantee a sufficient governance safeguard if they lack HC and SC in the forms of knowledge, expertise, and networking (Hillman & Dalziel, 2003; Kroll et al., 2008). Without sufficient HC and SC, the ability of INEDs “to understand and contribute to strategy or effectively monitor performance in complex business” (Mire, 2016, p. 3), may be limited. Since the contributions of INEDs to the boards may vary based on their unique HC and SC (Kor & Sundaramurthy, 2009), many recent researchers recommended for future studies to incorporate INEDs' HC and SC when examining board's effectiveness (Carpenter & Westphal, 2001; Hillman & Dalziel, 2003; Khanna et al., 2014).

In Malaysia, the importance of directors' HC and SC has been highlighted in the MCCG 2000. The Code states that:

Non-executive directors (including INEDs) should be persons of calibre, credibility, and have the necessary skill and experience to bring an independent judgement to bear on the issues of strategy, performance, and resources including key appointments and standards of conduct. (p. 9).

INEDs are appointed because of the resources that they can bring to the boardroom. Thus, INEDs' HC and SC are vital criteria that will be considered by the nominating committees in the selection of INEDs. The MCCG 2000 also requires the nominating committee to “annually review its required mix of skills and experience and other

qualities, including core competencies which non-executive directors should bring to the board. This should be disclosed in the annual report” (p. 10).

As discussed in Section 2.6.2, HC and SC composed of multidimensional constructs, and this is reflected on how the constructs were measured by earlier research. This study focuses on three important constructs of INEDs’ HC and SC, namely (i) INEDs’ functional knowledge in accounting and finance; (ii) INEDs’ firm-specific knowledge; and (iii) INEDs’ external networking. These three attributes had been identified to play a crucial role in enhancing INEDs’ monitoring and advisory roles (Guldiken & Darendali, 2016; Johnson et al., 2013; Kor & Sundaramurthy, 2009; Stevenson & Radin, 2009). Such constructs were argued to affect what directors (including INEDs) pay attention to and how they frame their decisions (Johnson et al., 2013).

Relying on resource dependence, human capital, and social capital theories, this study examines the moderating effects of INEDs’ functional knowledge in accounting and finance, INEDs’ firm-specific knowledge, and INEDs’ external networking on the relationship between RPTs and firm performance. This study argues that INEDs who have higher functional and firm-specific knowledge, as well as external networking, are subject to less information asymmetry (Guldiken & Darendali, 2016). This is because, being equipped with these valuable resources provides them with better access to more and higher quality information (Carpenter & Westphal, 2001; Tian et al., 2011) which may lead to more effective information processing and decision-making ability (Tian et al., 2011). Consequently, INEDs with high level of HC and SC were argued to better detect insiders’ opportunism (Guldiken & Darendali, 2016) and therefore, can limit RPTs that damage firm performance. In addition, resource-rich

INEDs can provide better advice and counsel to the managers and controlling shareholders in conducting more efficient RPTs.

3.4.3.1 Functional Knowledge in Accounting and Finance

Functional knowledge relates to knowledge in finance, accounting, legal, marketing, and economics (Carmeli, 2006; Hambrick & Manson, 1984). Knowledge in accounting and finance has been recognised as one of the important criteria for INEDs to fulfil their monitoring role. Previous studies provided evidences that INEDs with functional knowledge in accounting and finance may (i) enhance the quality of financial reporting process; (ii) reduce the likelihood of fraud and earnings restatements; (iii) be more effective in mitigating earnings management; and (iv) be less likely to be associated with the occurrence of internal control problems (Agrawal & Chadha, 2005; Carcello et al., 2006; Krishnan, 2005). Due to the benefits associated with financial expertise that INEDs bring into a firm, the MCCG 2007 strongly recommended that all members of the audit committee should be non-executive directors who are financially literate, and at least one director should be a member of an accounting association or body. This recommendation is mandated in Chapter 15.09 of the BMLR.

With regards to RPTs, one of the essential roles of INEDs is to monitor and to ensure that RPTs are conducted in the best interest of the company and its minority shareholders. The details of their duties have been discussed in the CGG 2013 issued by Bursa Malaysia. Among others, they are responsible to review RPTs and conflict of interest situations, and ensure that RPTs are fair, reasonable, and are not prejudicial to the interests of the company or its minority shareholders. They also need to warrant

that a proper and comprehensive framework for the identification, monitoring, evaluation, approval, and reporting of RPTs is established. Therefore, knowledge in accounting and finance appears to be desirable for INEDs to fulfil their tasks.

It is expected that INEDs with accounting and finance background have a better understanding of the underlying nature of RPTs, including the identification of related entities or related persons involved in RPTs and the terms on which such transactions are conducted. In addition, being equipped with accounting and finance knowledge enables INEDs to monitor and ensure that RPTs are properly disclosed in a firm's financial statements. Kohlbeck and Mayhew (2010) argued that transparent disclosure of RPTs could provide users of financial statements with the necessary information to either (i) value RPTs; (ii) discipline opportunistic behaviour of the controlling parties; or (iii) take precaution against the controlling shareholders' opportunism.

RPTs are usually performed through complicated transactions between the firm and its managers, directors, subsidiaries, and major shareholders, making them a potential platform for insiders' opportunism. Pucek and Richards (2013) contended that many RPTs have "substance over form" problems and some of them are embedded in the documentation that is less clear or thorough compared to the documentation that ordinarily exists among unrelated parties. This provides opportunities for the insiders to engage in abusive RPTs.

Both anecdotal evidence (such as Enron and WorldCom) and empirical evidence (see Aharony et al., 2010; Gordon & Henry, 2005; Haji Abdullah & Wan Hussin, 2015; Hasnan et al., 2016; Jian & Wong, 2010; Munir et al., 2013) revealed that RPTs are

one of the contributing factors to the numerous accounting failures and fraud. Due to the complicated nature of RPTs, this study therefore suggests that INEDs who have sound knowledge in accounting and finance are expected to undertake the key responsibility in detecting any potential risk associated with RPTs. INEDs with substantial knowledge in accounting and finance are anticipated to be better able to constrain disadvantageous RPTs which consequently, will enhance firm performance. The above reasoning leads to the following hypotheses:

H3 INEDs' functional knowledge in accounting and finance weakens the negative relationship between RPTs and firm performance.

H3a INEDs' functional knowledge in accounting and finance strengthens the positive relationship between RPTs with related entities and firm performance.

H3b INEDs' functional knowledge in accounting and finance weakens the negative relationship between RPTs with related persons and firm performance.

3.4.3.2 Firm-Specific Knowledge

The resource dependence and human capital theories hold that INEDs who have detailed knowledge about the focal firm and an intimate understanding of its operation may have better ability to effectively perform their monitoring and advisory roles (Hillman & Dalziel, 2003; Kor & Sundaramurthy, 2009). As part-time board members, INEDs are considered as less informed than the internal directors (Bhagat & Black, 2002), and this limits their ability to monitor effectively (Huang, 2013). This is more likely to be the case for short-tenured INEDs (Huang, 2013).

However, over the passage of their tenure, INEDs can accumulate firm-specific information and knowledge (Brown, Anderson, Salas, & Ward, 2017). Therefore, INEDs who had served the board for a longer period of time are argued to have greater firm-specific knowledge. With the firm-specific information and knowledge, INEDs can provide superior monitoring of the management and controlling shareholders. Moreover, having in-depth knowledge of the firm enables them to evaluate the activities of the controlling shareholders more accurately due to their familiarity with the firm's focal resources and capabilities (Guldiken & Darendeli, 2016; Kor & Sundaramurthy, 2009).

Furthermore, the social capital theory postulates that during serving on a particular board, INEDs can build internal SC in terms of more intimate knowledge and familiarity about the top management's skills and personalities. Consequently, they can interpret the information received from the top management more accurately. Long tenure can also increase INEDs' familiarity with other board members' skills, habits, and personalities, thereby enabling them to function and make decision effectively as a group (Fisher & Pollock, 2004; Kor & Sundaramurthy, 2009; Westphal & Bednar, 2005).

It is expected that the controlling shareholders in firms where board is dominated by short-tenure INEDs, by virtue of their informational advantage, have strong incentive to use RPTs to expropriate wealth from the minority shareholders. Short-tenure INEDs, due to their firm-specific knowledge deficit, are unable to challenge the decision made by the controlling shareholders. Firm's wealth can be exploited by the controlling shareholders who set unfair terms for RPTs (Claessens et al., 2002; Shleifer

& Vishny, 1997). Thus, limited oversight by short-tenure INEDs allow the controlling shareholders to expropriate from the minority shareholders and this in turn will reduce firm performance.

In contrast, boards where directors have longer tenures are less likely to approve disadvantageous RPTs, thus, offering better protection to the minority shareholders. This is because INEDs with substantial firm-specific knowledge are more willing to debate and express their opinion and consequently, can exert significant influence in the decision-making process involving RPTs. Tacit knowledge of the firm and its operations provides INEDs with the information necessary for identifying the opportunities and threats that RPTs present to the firm. Plus, greater familiarity with firm's capabilities, habits, abilities, and limitations (Dost et al., 2016) allows INEDs to understand the context for their decision making (Mire, 2016), and this can help them to differentiate between legitimate and illegitimate RPTs. Firm-specific knowledge enables the INEDs to monitor, evaluate, and provide valuable advices to the senior management (Kor & Sundaramurthy, 2009).

It is expected that when RPTs are monitored by INEDs who have higher level of firm-specific knowledge, the controlling shareholders may avoid engaging in value-decreasing RPTs. In addition, through their advisory role, INEDs that have in-depth knowledge about firm's resources and abilities can offer advice to the managers on how RPTs can be strategized to benefit the firm through contract efficiency, strategic feedback, and investment facilitation (CFA Institute, 2009). They may also provide advice on matters concerning the firm's internal control system on RPTs to ensure that

the system is sufficiently designed and effectively operated. This is expected to reduce value-decreasing RPTs, which in turn, will contribute to increase firm performance.

Recently, the Malaysian regulators have expressed concern about the director tenure. The revised MCCG 2012 recommends limiting the services of INEDs to a maximum of nine years with the justification that long tenure may impair their independence. However, this recommendation is contradicting with the argument of the resource dependence, human capital, and social capital theories. Therefore, further research is required to provide evidence on this matter. Based on the above discussion, this paper posits the following hypotheses:

H4 INEDs' firm-specific knowledge weakens the negative relationship between RPTs and firm performance.

H4a INEDs' firm-specific knowledge strengthens the positive relationship between RPTs with related entities and firm performance.

H4b INEDs' firm-specific knowledge weakens the negative relationship between RPTs with related persons and firm performance.

3.4.3.3 External Networking

From the perspective of the social capital theory, external networking or external ties refer to the linkages that involve other party outside the organisation (Hillman & Dalziel, 2003; Kim, 2007; Melkumov & Khoreva, 2015). There are valuable resources attached within, available through, and derived from such networking possessed by an

individual (Nahapiet & Ghoshal, 1998). The resources obtained from external networking, which include information and knowledge, will lead to the individual's ability to speak up and influence decisions. Thus, they are considered as key elements of the SC perspective (Stevenson & Radin, 2009).

The ability of an individual to exploit such resources via his or her external networking offers him or her personal contacts that can be critical to his or her career advancement (Kim, 2007; Kor & Sundaramurthy, 2009). When a firm appoints such person as its director, he or she is expected (i) to provide higher, newer, and potentially more valuable information from outside the firm (Barroso-Castro et al., 2015; Carpenter & Westphal, 2001; Hillman et al., 2000; Pfeffer & Salancik, 1978; Zahra & Pearce, 1989), (ii) to extract resources and gain support from influential external stakeholders (Barroso-Castro et al., 2015; Hillman et al., 2000; Kiel & Nicholson, 2006; Kim & Cannella, 2008; Zahra & Pearce, 1989), and (iii) to enhance the firm's legitimacy (Pfeffer & Salancik, 1978; Zahra & Pearce, 1989). With the various benefits attached to external networking, it plays a crucial role in the decision to select any director, in the boardroom context (Kim & Cannella, 2008).

Board capital scholars suggested that INEDs' external networking, which includes networking with other directors and executives, can be developed through holding external directorships in other companies (Hillman & Dalziel, 2003; Kor & Sundaramurthy, 2009). These external connections that they bring into the board of the focal firm can provide the firm with quick access to timely information and critical resources (Kor & Sundaramurthy, 2009). Accordingly, multiple directorships can

increase INEDs' SC and hence, enhance the quality of INEDs in both monitoring and advisory activities.

In addition, consistent with the quality hypothesis, having multiple directorships also exposes INEDs to numerous governance and strategic issues, including regarding RPTs. INEDs who have experience in dealing with RPT issues in other firms are expected to be effective in monitoring the controlling parties' opportunism. Furthermore, the exposure can enrich the general skills and knowledge of the INEDs. These skills and knowledge that INEDs develop by serving on multiple boards are transferable and thereby, can improve their ability to provide effective monitoring and to offer valuable advice to the focal firm in dealing with numerous problems (Carpenter & Westphal, 2001; Kor & Sundaramurthy, 2009).

As RPTs are mainly operated through an extensive and complex range of relationships and structures, the involvements of INEDs who can bring diverse perspective and knowledge obtained via multiple board appointments are required for the board to have better access towards the consequences of their decisions. Diverse range of knowledge may make INEDs more aware of issues relating to RPTs. With this knowledge, they can guide managers to make the right decisions in dealing with RPTs or to avoid harmful transactions.

In addition, well-informed INEDs are more likely to develop a questioning culture, which in turn lead to more in-depth discussion regarding the appropriateness of RPTs. They also tend to analyse RPT decisions made by a company more thoroughly. This kind of analysis reduces the potential for unethical decisions, as well as those that may

harm a company's reputation. Therefore, this study argues that the effect of RPTs on firm performance is dependent on the level of INEDs' external networking. Specifically, it is expected that the presence of INEDs with high level of external networking can help a firm to detect and avoid the appearance of RPTs with conflict of interest and subsequently, transfer these transactions to efficient RPTs. As a result, the firm performance would be improved.

Multiple directorships are legally recognised in Malaysia (Hasnan et al., 2016). However, the MCCG 2012 raises concern on the time commitment of having multiple directorships. It is argued that directors who serve on multiple boards are less effective in monitoring the controlling parties as they are occupied in serving other boards. With this reason, the BMLR recently imposed a limit of five directorships in PLCs. Nonetheless, despite that argument, the empirical evidence against multiple directorships is far from being conclusive. Therefore, further research is needed to shed more light on this matter. Based on the argument put forward by the resource dependence and social capital theories, this study posits the following hypotheses:

H5 INEDs' external networking weakens the negative relationship between RPTs and firm performance.

H5a INEDs' external networking strengthens the positive relationship between RPTs with related entities and firm performance.

H5b INEDs' external networking weakens the negative relationship between RPTs with related persons and firm performance.

3.5 Conclusion

This chapter discussed the theoretical framework underlying the development and formulation of the research hypotheses. In the initial part, this chapter discussed the agency theory thoroughly in explaining the effect of RPTs on firm performance and the extent on how the proportion of INEDs moderates the relationship between RPTs and firm performance. Subsequently, this chapter discussed how the resource dependence, human capital, and social capital theories are being used to explain the moderating effects of INEDs' HC and SC on the RPTs-firm performance relationship. These capitals cover the INEDs' functional knowledge in accounting and finance, INEDs' firm-specific knowledge, and INEDs' external networking under the regulatory framework for RPTs in Malaysia.



CHAPTER FOUR

RESEARCH DESIGN

4.1 Introduction

This chapter presents a detailed discussion of the sample selection and the methodology of this research. The chapter is organized as follows: Section 4.2 outlines research design, and Section 4.3 outlines sample of this study. Section 4.4 discusses the sources of data. Section 4.5 explains the variables definition and measurement. Section 4.6 presents the regression model used to test the relationship between RPTs and firm performance and the moderating effects of the proportion of INEDs and their human capital (HC) and social capital (SC) on RPTs-firm performance relationship. Finally, Section 4.7 concludes the chapter.

4.2 Research Design

To reiterate, the objectives of this study are:

- (a) To examine the effect of RPTs (based on total RPTs and types of related parties) on firm performance.
- (b) To investigate the moderating effect of the proportion of INEDs on the relationship between RPTs (based on total RPTs and types of related parties) and firm performance.
- (c) To analyse the moderating effect of INEDs' HC on the relationship between RPTs (based on total RPTs and types of related parties) and firm performance.
- (d) To analyse the moderating effect of INEDs' SC on the relationship between RPTs (based on total RPTs and types of related parties) and firm performance.

To accomplish the above-mentioned objectives, this study uses quantitative approach where data from selected firms are collected and analysed using statistical tests. The statistical tests are based on the cross-sectional analysis.

The year 2013 is chosen because (a) It is the most recent data available at the start of this research. Findings from this study are expected to provide additional evidence on the topic of interest; (b) RPTs data for the year 2013 can capture the effect of the revised standard of MFRS 124 Related Party Disclosures which is applicable for periods beginning on or after 1 January 2012. The revised MFRS 124 simplifies the definition of related party, clarifies its intended meaning and eliminates inconsistencies from the definition and gives partial exemption from disclosures for government-related entities; (c) It can take into account the effect of Corporate Governance Blueprint 2011 released by Securities Commission Malaysia in 2011 and the updated MCCG 2012 on RPTs and INEDs. The Corporate Governance Blueprint 2011 and the revised MCCG 2012 require all listed companies to beef up the roles and responsibility of INEDs. The revised MCCG 2012 focuses, among other, on the independence of INEDs and director's tenure limit; (d) This period is relatively stable in Malaysia both politically and economically and therefore variables tested in this study are expected to not be influenced by a large number of external factors. A one-year study period is considered sufficient due to the complexity and time required for hand collection of RPTs and INEDs data.

4.3 Sample

The population of this study consists of all firms listed on the Main Market of Bursa Malaysia for the year ended 2013. All finance firms including banking, insurance, trust, closed-end funds and securities are excluded from this study due to their unique characteristics, and are operated in different compliance and regulatory environment (Yatim, Kent, & Clarkson, 2006) and their performance data are not easy to calculate and to compare with firms in other industries (Claessens et al., 2002).

Table 4.1 shows that the total number of firms listed on the Main Market of Bursa Malaysia in 2013 is 811 firms. However, 54 firms are excluded from the population because these firms belong to finance industry.

Table 4.1
Research Population

	No. of Firms
Firms listed on the Main Market of Bursa Malaysia	811
(-) Finance related firms, bank, insurance and unit trust	54
Research population	757

This study uses Krejcie and Morgan's (1970) table as the guideline for estimating the required sample size. For a population of 800, Krejcie and Morgan (1970) suggested that a sample size of 260 (equivalent to 32.5%) is needed to represent the population. To be conservative, this study selects 300 firms which is about 40% of the population. The sample size of 300 is adequate as it is more than the recommended size by Krejcie and Morgan (1970). According to social science scholars such as Aaker and Day (1986), the use of samples is adequate and sufficient if the size of research population is large or when the cost or length of data collection from the population is high.

The sample firms in this study were selected based on proportionate stratified random sampling. This technique, as suggested by Cavana and Delahaye (2001), is more likely to produce a representative sample and is therefore the most efficient among all probability samplings such as simple random sampling, systematic random sampling and cluster random sampling (Sekaran, 2000). In stratified random sampling approach, sample elements are categorized into non-overlapping groups called strata and the elements are selected from each stratum using simple random sampling procedure (Sekaran, 2003). To apply this approach, the sample firms were firstly grouped into eleven industries based on the classification by Bursa Malaysia. Bursa Malaysia sector classification includes construction, consumer product, hotel, industrial product, IPC, Mining, Plantations, Properties, SPAC, technologies and trading/services. Secondly, to determine the number of sample for each industry, the number of firms in each industry was to be proportionate to the total number of sample. Finally, a random sample was generated for each industry. In this study, the random sampling was generated through online number generator. Table 4.2 shows the number of sample firms for each industry.

Table 4.2
Number of Sample Firms by Industry in 2013

Industry	Total Number of Firms	% of Population	No. of Sample Firms
Constructions	43	5.7	17
Consumer product	128	16.9	51
Hotel	4	0.5	2
Industrial product	235	31.0	93
IPC	6	0.8	2
Mining	1	0.1	0
Plantation	41	5.4	16
Properties	87	11.5	35
SPAC	2	0.3	1
Technology	30	4.0	12
Trading and services	180	23.8	71
Total	757	100	300

4.4 Sources of Data

Data for the selected firms were collected from two main sources: Annual Reports and DataStream. The English version of annual reports for the period of 2013 were obtained either from the Bursa Malaysia website at www.bursamalaysia.com.my or from the website of the particular company. Annual reports are utilized as the source of RPTs and INEDs data because these reports are widely used by investors and the public to make their investment decisions (Cascino et al., 2014). Besides, information released by annual reports is more reliable as it has been audited by independent and qualified auditors.

Due to unavailability of digital database, the sample data (including RPTs, proportion of INEDs and INEDs' HC and SC, corporate governance and ownership structures) were manually retrieved from firm's annual reports. RPTs are typically disclosed in the Related Party Disclosures note, the Directors' Remuneration note or in the Directors' Report. The information disclosed in these sections include related party relationships, types of transactions and the amount of transactions. The data relating to INEDs (i.e. number of INEDs and their HC and SC constructs) were obtained under the board of directors' profile. Other financial data for the year 2013 were obtained from DataStream.

4.5 Variables Definition and Measurement

4.5.1 Dependent Variable: Firm Performance

Performance measurement relates to the process of measuring the efficiency and effectiveness of actions (Neely, Gregory, & Platts, 1995). Following prior studies (e.g. Abdul Wahab, 2011; Munir et al., 2013), this study used return on assets (ROA) as the main proxy for firm performance. ROA is the ratio of net profit to the book value of assets (Abdul Wahab et al., 2011; Chien & Hsu, 2010; Haniffa & Hudaib, 2006; Klapper & Love, 2004; Munir et al., 2013). The ratio indicates how profitable a company is relative to its total assets. Firm performance is argued to be affected by practicing good corporate governance policies, and therefore ROA gives an indicator of how efficient and effective management is at using its assets to generate earnings (Khatab, Masood, Zaman, Saleem, & Saeed, 2011; Neely et al., 1995). The ratio has been used extensively by scholars studying corporate governance effectiveness (Chien & Hsu, 2010; Haniffa & Hudaib 2006).

4.5.2 Independent Variables: Related Party Transactions

In Malaysia, the scope and disclosures of related parties and transactions are set out in MFRS 124 Related Party Disclosures, Part E of Chapter 10 of the BMLR and the Companies Act 2016. RPTs as prescribed in MFRS 124 include purchases or sales of goods, purchases or sales of property and other assets, rendering or receiving of services, leases, transfers of research and development, transfers under license agreements and finance arrangements, provision of guarantees or collateral, commitments to do something if a particular event occurs or does not occur in the future and settlement of liabilities on behalf of the entity or by the entity on behalf of that related party. Details of the disclosures are discussed in Chapter 2 under Section 2.2.3. The RPTs are measured as the sum of the monetary values of RPTs disclosed in the 2013 annual reports for each listed firm in the sample, scaled by the total assets of the firm as at the fiscal year of 2013 (Abdul Wahab et al., 2011; Al-Dhamari et al., 2017; Hasnan et al., 2016). A higher value of RPTs indicate that such transactions pose a greater conflict of interest (Abdul Wahab et al., 2011)

This study extends prior research by examining whether different types of related parties affect firm value differently. The types of related parties are categorized according to the definition of “related party” in paragraph 9 of MFRS 124. The definition has been discussed in detail in Chapter 2 under section 2.2.1. Related parties are specifically classified into two main groups. The first group is related entities which include transactions with subsidiaries, associates and joint ventures (RPTRE). The second group is related persons, which include transactions with directors, major shareholders, persons connected with directors or major shareholders or director related entities (RPTRP) (see Appendix B). The classification is also consistent with

Nekhili and Cherif (2011). Please refer to Appendix C to see example of classification type of related parties.

The importance of examining the effect of different types of related parties on firm performance is in line with the argument put forth by Ryngaert and Thomas (2012) that not all RPTs are undertaken for expropriation purposes. Many RPTs are legitimate and conducted for genuine business reasons (Gordon et al., 2004). Therefore, considering all RPTs as harmful transactions would cause high measurement error.

Nekhili and Cherif (2011) argued that transactions with subsidiaries, associates and joint ventures are not always conducted to violate minority shareholder rights. Moreover, the prevalence of company groups is common especially in emerging economies like Malaysia (OECD, 2012). Under this structure, RPTs are mainly carried out with members of a company group for sound business purposes (OECD, 2012). For example, company groups can make use of RPTs to reduce transaction costs and to achieve more efficient asset utilization (Khanna & Palepu, 2000). Transactions involving related persons may however have the potential to expropriate minority shareholders (Nekhili & Cherif, 2011).

The procedure to measure these variables are similar with total RPTs where the aggregate monetary values of RPTRE and RPTRP are divided by the total assets (Abdul Wahab et al., 2011; Al-Dhamari et al., 2017; Hasnan et al., 2016).

4.5.3 Moderating Variables: Independent Directors

This study focuses on INEDs at the board level and not solely at the audit committee level. As discussed in Chapter 2.5.4.1, the role to review RPTs in Malaysia is normally assigned to audit committee and remuneration committee. In certain company, RPTs committee is established to review conflict of interest situations and RPTs. Due to the involvement of INEDs in these committees, this study therefore examines the role played by INEDs at the board level.

The Proportion of Independent Directors

INEDs are formally defined in paragraph 1.01 of the BMLR as a director who is independent of management and free from any business or other relationship which could interfere with the exercise of independent judgement or the ability to act in the best interests of the company. The agency theory argues that boards dominated by INEDs are better able to protect the interests of shareholders.

The proportion of INEDs (INEDPROP) is regarded as a proxy of board independence and measured as a total number of INEDs to the total number of directors (Abdul Wahab et al., 2011; Cheung et al., 2006; Chien & Hsu, 2010; Hasnan et al., 2016; Nekhili & Cherif, 2011)

Independent Directors' Human Capital and Social Capital

The resource dependence, human capital and social capital theories postulate that INEDs having a mix of skills, expertise, knowledge and networking, are expected to have the ability to limit the insiders' self-serving behavior. This study focuses on two constructs of INEDs' HC (i.e. INEDs' functional knowledge in accounting and finance

[INEDFUNK], and INEDs' firm-specific knowledge [INEDSPEK], and one construct for INEDs' SC (i.e. INEDs' external networking [INEDNET]). The selection of these constructs is in line with other studies such as Chen (2014), de Villiers et al. (2011), Guldiken and Darendeli (2016), Johnson et al. (2013), Kor and Sundaramurthy (2009) and Tian et al. (2011). Moreover, the measurement of the constructs, which include financial expertise, tenure and directorships among INEDs, have been the focus in the corporate governance reforms as discussed in Chapter 2.5.3. The constructs were measured as below:

- (a) INEDFUNK was calculated based on the total number of INEDs with financial expertise divided by the total number of INEDs (Carcello & Neal 2003; Hoitash, Hoitash, & Bedard, 2009; Zhang, Zhou, & Zhou, 2007).

INEDs have a role to ensure that a proper and comprehensive framework for the identification, monitoring, evaluating, approving and reporting of RPTs is established by a firm. Therefore, the human capital theory suggests that to effectively fulfill these roles, INEDs are required to have specialized and functional accounting/finance knowledge.

INEDs are considered to have accounting and financial knowledge if they have experience as: (a) a certified public accountant, auditor, principal, chief financial officer, controller, or chief accounting officer; or (b) a chief executive officer, president, or chairman of the board in a for profit corporation, or who has experience as the managing director, partner or principal in venture financing,

investment banking, or money management (Carcello & Neal, 2003; Hoitash et al., 2009; Zhang et al., 2007).

- (b) INEDSPEK was measured based on the total INEDs' tenure divided by the total number of INEDs in the firm (Fisher & Pollock, 2004; Hitt, Bierman, Shimizu, & Kochhar, 2001; Kor & Sundaramurthy, 2009).

The human capital theory argues that length of tenure is an indicator of a director's knowledge, commitment and expertise. INEDs who have served on the boards for an extended period of time can develop firm-specific knowledge, and thereby enable them to provide superior monitoring of the management and controlling shareholders.

- (c) INEDNET was measured as the total number of INEDs' directorships at other firms divided by the total number of INEDs (Chen, 2013; Ferris, Jaganathan, & Pritchard et al., 2003; Kor & Sundaramurthy, 2009; Tian et al., 2011).

The human capital and social capital theories suggest that serving on multiple boards may signal superior quality of INEDs and provide INEDs with valuable sources of knowledge and information on different management skills and business network contacts, which could enable them to enhance board functions as well as shareholders value. In this study, only outside directorships in PLCs will be considered because not all companies provide information about the outside directorships in private companies (Kamardin, Abdul Latif, Taufil Mohd, & Che Adam, 2014).

4.5.4 Control Variables

To control for firm, governance, and ownership effects on firm performance, this study included a series of control variables including audit quality (BIG4), board size (BSIZE), firm size (FSIZE), leverage (LEV), controlling shareholders ownership (CSOWN), type of controlling shareholders (CSTYPE), managerial ownership (MOWN) and industry classifications (INDUSTRY). These control variables have been used in prior studies and have been proven to affect firm performance (Abdul Wahab et al., 2011; Cheung et al., 2009; Gordon et al., 2004; Haniffah & Hudaib, 2006; Sulong & Mat Nor, 2008; Tam & Tan, 2007).

Audit Quality (BIG4)

Audit quality refers to whether the firm is audited by large (BIG4) or small (non-BIG4) audit firms. In audit quality literature, size of audit firm is commonly viewed as a surrogate for audit quality (DeAngelo, 1981; Krishnan & Schauer, 2000). Large-scale audit firms are argued to have abundant resources, such as HC and information technology, and are therefore more likely to provide high quality service than small audit firms. Due to their reputation, large audit firms are expected to conduct audit works in a manner that minimizes the risk of significant misstatements and error in financial statements and ensures that the financial statements are prepared according to specific rules and regulations (DeFond & Jiambalvo, 1993; DeAngelo, 1981). Prior studies provided evidence that audit quality as external monitoring can enhance firm performance (Afza & Nazir, 2014; Farouk & Hassan, 2014).

RPTs involve complex network of relationships, making them difficult to audit (Nekhili & Cherif, 2011). According to Mitton (2002), expropriation of minority

shareholders seems more probable when RPTs are difficult to detect, and therefore having high quality external auditors can overcome potential expropriation problems. Bennouri, Nekhili and Thouron (2015) provided evidence that big audit firms are more effective than non-big audit firms in limiting the number of RPTs suggesting that they can be considered as effective governance mechanism in limiting the expropriation of minority shareholders.

In this study, audit quality (BIG4) was measured by a dummy variable that takes the value “1” if the firm is audited by Big 4, and “0” otherwise (Gallery et al., 2008; Khosa, 2017; Munir et al., 2013).

Board Size (BSIZE)

Board size refers to the total number of directors on the board. The literature concerning corporate governance offers the following argument relating to the relationships between board size and board effectiveness. On one hand, small board of directors are more effective than larger ones because the board can communicate and coordinate their work well, and have less incidents of a severe free-rider problems (Fama & Jensen, 1983; Klein, 2002; Yermack, 1996). This in turn increases the efficiency of the board and leads to increase firm performance. Gordon et al. (2004) provided evidence that board size is inversely related with RPTs suggesting that an increase in the number of directors reduces the ability of the board in monitoring RPTs.

On the other hand, large board size may perform the monitoring role better than small board due to the advantage of more information and diverse backgrounds which

subsequently lead to increase firm performance (Dalton, Daily, Johnson & Ellstrand, 1999).

In this study, board size (BSIZE) was measured as the number of total directors on the board, including executive and non-executive directors (Abdul Wahab et al., 2011; Cheung et al., 2006; Gao & Kling, 2008; Hasnan et al., 2016; Khosa, 2017).

Firm Size (FSIZE)

Firm size has been found to be associated with firm performance. From economies of scale view, firm size is expected to be related positively with firm performance due to financial, organizational and technical reasons (Maja & Josipa, 2012). For instance, larger firms can get a better interest rate and have specialization and division of labour (Maja & Josipa, 2012). Larger firms also have greater resources and easier access to international markets (Lopez-Valeiras, Gomez-Conde, & Fernandez-Rodriguez, 2016). Due to this reasons, firm size can be a source of competitive advantage as larger firms are expected to be relatively more efficient than smaller firms (Hawawinin, Subramanian, & Verdin, 2003).

Contrary to this, the managerial firms' perspective suggests that larger firms are largely under the control of managers pursuing self-interested goals and therefore the main objective of firms to maximize profit for the shareholders may be substituted by managerial utility maximization objective (Maja & Josipa, 2012). Therefore, firm size is expected to inversely relate to firm performance (Haniffa & Hudaib, 2006).

In this study, firm size (FSIZE) was measured as the natural log of total assets of the firm (Aharony et al., 2006; Cheung et al., 2006; Chien & Hsu, 2010; Munir et al., 2013).

Leverage (LEV)

Leverage has been widely used as a control variable in a number of empirical research. It is argued that leverage may affect firm performance either positively or negatively. Highly leverage firms are more strongly monitored by lenders and may consequently affect firm performance positively (Agrawal & Knoeber, 1996; Jensen, 1986). Jensen and Meckling (1976) provided evidence that leverage plays a significant role in alleviating agency problem. Gordon et al. (2004) suggested that leverage is negatively associated with harmful RPTs but positively related to efficient RPTs. In addition, leverage can be used as a disciplinary device that can reduce the amount of free cash flow available to managers (Jensen, 1986). By reducing the amount of free cash flow, leverage can prevent managers from investing in unprofitable investment projects, thereby increasing firm performance.

On the other hand, Myers (1977) argued that leverage can worsen firm performance due to underinvestment or investment in overly risky projects (Jensen & Meckling, 1976). Firms with higher financial leverage have greater agency costs due to conflict of interest between owners and creditors (Jensen & Meckling, 1976). Owners support investment in riskier projects as they gain from potential profits, while the creditors bear the losses. Thus, a negative association between leverage and firm performance is expected.

This study measured LEV as the ratio of total debt to total assets (Abdul Wahab et al., 2011; Jian & Wong, 2004; Khosa, 2017; Nekhili & Cherif, 2011).

Controlling Shareholder Ownership (CSOWN)

Previous studies (e.g. La Porta et al., 1999; Claessens et al., 2000) provided evidence that ownership structure of many firms around the world and particularly in East Asian countries is concentrated in the hand of a few large shareholders. Consistent with the incentive alignment effect, ownership structure with large shareholders can benefit minority shareholders by closely monitoring managers and hence maximizing firm value (Shleifer & Vishny, 1986, 1997). The presence of large shareholders can also mitigate the free rider problem of monitoring a management team (Shleifer & Vishny, 1986). However, such a structure creates problems between controlling shareholders and minority shareholders. From the perspective of entrenchment effect, the presence of large shareholders can be harmful to minority investors if they pursue private benefits that differ from profit maximization activities or if they reduce valuable managerial incentives (Shleifer & Vishny, 1997). Fan and Wong (2002) argued that when controlling shareholders hold effective control over the firm, they also control the production of the firm's information to the public. There is therefore a tendency that they may hide any wrongdoing (e.g. expropriation of minority shareholders) by avoiding reporting detailed and truthful accounting information. Thus, a negative association between controlling shareholders and firm performance is expected.

In this study, I defined controlling shareholders ownership (CSOWN) as the ownership share of the five largest shareholders (Haniffa & Hudaib, 2006; Rahmat & Ali, 2016). The ownership data was collected manually by examining the analysis of

shareholdings section discloses in the annual reports. CSOWN was measured by the proportion of shares owned by the five largest shareholders to total shares outstanding in the company (Haniffa & Hudaib, 2006; Rahmat & Ali, 2016).

Type of Controlling Shareholders (CSTYPE)

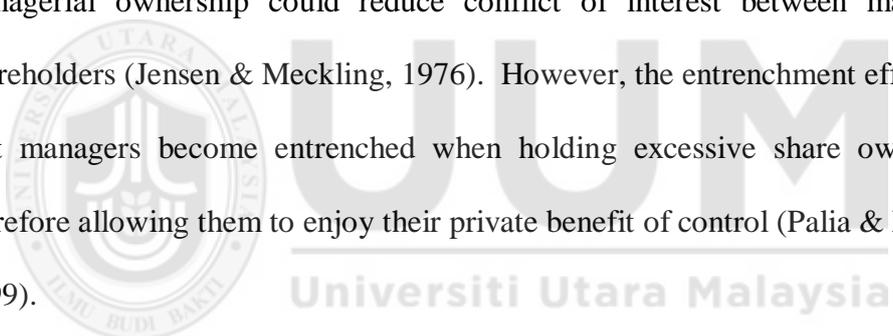
The effects of the controlling shareholders on firm performance may differ according to the types of the controlling shareholders (Wiwattanakantang, 2001). Firms in Malaysia are largely family controlled (Claessens et al., 2000; Faccio & Lang, 2002). According to Amran and Che Ahmad (2013), families' business style, culture, race and regulations may influence the ownership structure in Malaysia. Prior studies documented that family firms are vulnerable to serious agency problems because of the conflict of interest between controlling families and minority shareholders (Anderson & Reeb, 2003; Morck & Yeung, 2003; Villalonga & Amit, 2006).

Family-controlled firms can make sub-optimal investment decisions since their interests are not necessarily in line with other shareholders (Amran & Che Ahmad, 2013; Fama & Jensen, 1985). In addition, restricted ownership reduces external monitoring, and this potentially lead to wealth expropriation from other shareholders (Morck, Strangeland, & Yeung, 2000). Munir et al. (2013) demonstrated that family-controlled firms are more likely to use RPTs to expropriate value from minority shareholders. Wiwattanakantang (2001) and Munir and Gul (2010) provided evidence that family firms have less market valuation suggesting investors may perceive the controlling shareholders to behave opportunistically towards minority shareholders.

In this study, type of controlling shareholders (CSTYPE) was a dummy variable that takes the value “1” if the controlling shareholder is individual or group of family and “0” otherwise (Rahmat & Ali, 2016).

Managerial Ownership (MOWN)

There are two opposing views on the effect of managerial ownership on firm performance: the incentive or the entrenchment effect (Palia & Lichtenberg, 1999). The incentive effect suggests that the behavior of managers becomes more aligned with shareholder interests when the managers hold higher ownership stake in the firm (Palia & Lichtenberg, 1999). The view is consistent with the agency theory that managerial ownership could reduce conflict of interest between managers and shareholders (Jensen & Meckling, 1976). However, the entrenchment effect suggests that managers become entrenched when holding excessive share ownership and therefore allowing them to enjoy their private benefit of control (Palia & Lichtenberg, 1999).



In this study, managerial ownership (MOWN) refers to where the managers (i.e. executive directors) are the shareholders of the company (Jensen & Meckling 1976; Mat Nor & Sulong, 2007). The ownership data was collected manually by examining the analysis of shareholdings section discloses in the annual reports. MOWN was measured based on the proportion of shares owned by executive directors of the company as a group to total shares outstanding (Haniffa & Hudaib, 2006; Rahmat & Ali, 2016).

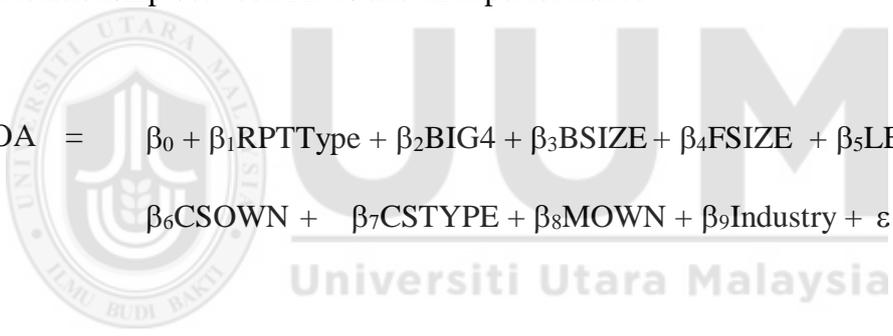
Industry (INDUSTRY)

This study also included industry type (INDUSTRY) as a control variable. INDUSTRY is a dummy variable for industry types and it is based on industry classification by Bursa Malaysia.

4.6 Research Model

To examine the relationship between RPTs and firm performance, and whether the proportion of INEDs and their HC and SC could mitigate the RPTs-firm performance relationship, this study employed the following regression models:

(a) Relationship between RPTs and firm performance:


$$\text{ROA} = \beta_0 + \beta_1\text{RPTType} + \beta_2\text{BIG4} + \beta_3\text{BSIZE} + \beta_4\text{FSIZE} + \beta_5\text{LEV} + \beta_6\text{CSOWN} + \beta_7\text{CSTYPE} + \beta_8\text{MOWN} + \beta_9\text{Industry} + \varepsilon \quad (4.1)$$

(b) Moderating effects of the proportion of INEDs and their HC and SC on the relationship between RPTs and firm performance:

$$\text{ROA} = \beta_0 + \beta_1\text{RPTType} + \beta_2\text{INEDVar} + \beta_3\text{RPTType*INEDVar} + \beta_4\text{BIG4} + \beta_5\text{BSIZE} + \beta_6\text{FSIZE} + \beta_7\text{LEV} + \beta_8\text{CSOWN} + \beta_9\text{CSTYPE} + \beta_{10}\text{MOWN} + \beta_{11}\text{Industry} + \varepsilon \quad (4.2)$$

Where:

- ROA : Return on asset = net profit divided by total assets
- RPTType : Related party transactions, and measured by:
(a) RPTs = total monetary values of RPTs divided by total assets
(b) RPTRE = total monetary values of RPTs with related entities divided by total assets
(c) RPTRP = total monetary values of RPTs with related persons divided by total assets
- INEDVar : INEDs' variables, and measured by:
(a) Proportion of INEDs (INEDPROP) = total number of INEDs divided by total number of directors

(b) INEDs' HC, capture by:
i. INEDs' functional knowledge (INEDFUNK) = total number of INEDs with financial expertise divided by total number of INEDs
ii. INEDs' firm-specific knowledge (INEDSPEK) = total number of years of service of all INEDs on the board divided by the total number of INEDs

(c) INEDs' SC, captured by INEDs' external networking (INEDNET)
INEDNET = total number of INEDs' directorships at other firms divided by total number of INEDs
- BIG4 : Audit firm = dummy variable coded "1" if the firm is audited by the Big-4 and "0" otherwise
- BSIZE : Board size = total members of the board of directors
- FSIZE : Firm size = natural log of total assets at the end of financial year
- LEV : Leverage = total debt divided by total assets
- CSOWN : Controlling shareholder ownerships = total number of shares owned by controlling shareholders divided by total number of firm's shares.
- CSTYPE : Type of controlling shareholders = a dummy variable coded "1" if the controlling shareholder is individual or group of family and "0" otherwise.
- MOWN : Managerial ownership = total number of shares owned by managers (i.e. executive directors) divided by total number of firm's shares
- INDUSTRY : Industry types = a dummy variable for industry types.

4.7 Conclusion

This chapter explains the methodology of the study. The sample selection was chosen from all non-financial firms listed on Bursa Malaysia in 2013. The final sample consists of 300 firms that represent about 40% of the population. The proportionate stratified random sampling was used to select the sample firms. The firms' data were collected either from companies' annual reports or Datastream. This chapter discusses the measurements of dependent (firm performance), independent (RPTs) and moderating (proportion of INEDs and INEDs' HC and SC) variables. This study also considers audit quality, board size, firm size, leverage, controlling shareholders ownership, type of controlling shareholders, management ownership and industry classifications as control variables.



CHAPTER FIVE

RESULTS AND DISCUSSION

5.1 Introduction

This chapter reports and discusses the results of this study. The chapter is structured as follows: Section 5.2 summarizes the descriptive statistics of the tested variables in the regression analysis. Section 5.3 reports the regression diagnostics. Then Section 5.4 presents the multivariate analysis of the direct relationships. Section 5.5 discusses the results of the moderating effects of the proportion of INEDs and their HC and SC (i.e. functional knowledge in accounting and finance, firm-specific knowledge and external networking) on the relationship between RPTs and firm performance. Section 5.6 provides the robustness check and finally Section 5.7 concludes the chapter.

5.2 Descriptive Analysis

Table 5.1 presents descriptive statistics of the variables used in this study. All continuous variables were winsorised at the 1st and 99th percentiles. Even though the winsorising procedure did not fully eliminate the outliers, it could at least limit the effect of extreme values. The procedure has been widely used in RPTs studies (Gordon et al., 2004; Jian & Wong, 2004; Kohlbeck & Mayhew, 2010; Wang & Yuan, 2012). The dependent variable of this study, ROA, represents the firm performance. The mean (median) of ROA was 0.038 (0.038) with a range of -0.511 to 0.358. The results indicate that listed firm in this study make about 3.8% of total assets as net income.

For the RPTs variables, of the 300 companies considered in this study, all companies (100%) disclosed RPTs and RPTs with related persons (RPTRP), while 251 companies (84%) disclosed RPTs with related entities (RPTRE). Table 5.1 shows that total RPTs

had a mean (median) value of 0.126 (0.059) with a standard deviation of 0.176. These statistics indicate that, on average, the size of RPTs in the sample of this study was 12.6% of the total assets ranging from a minimum value of 0% to a maximum of 94.6%. The figure was not much different from previous RPTs studies in Malaysia. For example, Abdul Wahab et al. (2011) and Al-Dhamari et al. (2017) reported that the size of RPTs among Malaysian firms was around 13.9% and 12%, respectively.

For the types of related parties, RPTRE and RPTRP had a mean (median) value of 0.063 (0.023) and 0.063 (0.017), and with standard deviation of 0.110 and 0.132 respectively. The results suggest that on average, transactions with related entities and with related persons equally contribute to RPTs in Malaysia.



Table 5.1
Descriptive Statistics of the Variables

n=300	Mean	Median	Minimum	Maximum	Std.Dev.
ROA	0.038	0.038	-0.511	0.358	0.097
RPTs	0.126	0.059	0.000	0.946	0.176
RPTRE	0.063	0.023	0.000	0.532	0.110
RPTRP	0.063	0.017	0.000	0.850	0.132
INEDPROP	0.465	0.429	0.286	0.800	0.120
INEDFUNK	0.439	0.333	0.000	1.000	0.245
INEDSPEK	6.857	6.583	1.000	20.000	3.818
INEDNET	1.243	1.000	0.000	5.000	1.080
BIG4	0.503	1.000	0.000	1.000	0.501
BSIZE	7.277	7.000	4.000	13.000	1.777
FSIZE	19.853	19.710	16.770	25.740	1.465
LEV	0.371	0.355	0.003	0.961	0.215
CSOWN	0.387	0.340	0.000	0.855	0.189
CSTYPE	0.507	1.000	0.000	1.000	0.501
MOWN	0.109	0.045	0.000	0.744	0.152

Notes: ROA = net profit divided by total assets; RPTs = the sum of the monetary values of RPTs scaled by the total assets; RPTRE = the sum of the monetary values of RPTRE scaled by the total assets; RPTRP = the sum of the monetary values of RPTRP scaled by the total assets; INEDPROP = total number of INEDs divided by total number of directors; INEDFUNK = total number of INEDs with financial expertise divided by total number of INEDs; INEDSPEK = INEDs' tenure divided by total number of INEDs; INEDNET = INEDs' directorships divided by total number of INEDs; BIG4 is a dummy variable coded 1 if the firm is audited by Big 4, and 0 otherwise; BSIZE = total number of directors on the board; FSIZE is natural log of total assets of the firm; LEV = total debt divided by total assets; CSOWN is the percentage of shares owned by controlling shareholder; CSTYPE is a dummy variable coded 1 if the controlling shareholder is individual or group of family and 0 otherwise; MOWN is the percentage of shares owned by management.

The proportion of INEDs on the board (INEDPROP) was 47%, which is beyond one-third of the minimum requirement set by the Bursa Malaysia and MCCG. The figure was approximately similar to the figure reported by Hasnan et al. (2016). Based on 294 firm-year samples for 2011–2012, Hasnan et al. (2016) found that the proportion of INEDs on the board of Malaysian companies was around 45%. Further analysis however, showed that there were about 8% (not reported) of the companies, where INEDs represented less than the recommended requirement.

For the constructs of INEDs' HC and SC, approximately 44% of INEDs have membership from accounting/professional bodies or have financial background

(INEDFUNK). The mean (median) of INEDs' firm-specific knowledge (INEDSPEK) was 6.857 (6.583) with a range of 1 to 20. The results indicate that the average tenure of INED is within the limit of 9 years as recommended by the MCCG 2012. For INEDs' external networking (INEDNET), the result shows that the average number of directorships held by an INED is approximately one (1) external directorship, ranging from a minimum value of 0 to a maximum value of 5. In terms of directorships, the results show that all of the Malaysian listed companies meet the recommendation of the BMLR to have up to 5 directorships in PLCs.

Table 5.1 also presents descriptive statistics of control variables used in this study. About 50.3% of the firms in this study are audited by Big 4 firms. The results are consistent with the study by Abdul Wahab et al. (2011), Munir et al. (2013) and Rahmat and Ali (2016). The average of board size (BSIZE) was 7 members and ranged from a minimum of 4 members to a maximum of 13 members. This is consistent with studies carried out by Haniffa and Hudaib (2006) and Hasnan et al. (2016). The size of the firm (FSIZE) as measured by the log of total assets varied from 16.77 to 25.74 with a mean of 19.85. The result is in line with the finding by Abdul Wahab et al. (2011). Leverage (LEV), represented by total debts to total assets, varied from a low of 0.3% to a high of 96.1% with 37.1% mean. This value indicates that some firms in this study are highly leveraged. The results are similar with Abdul Wahab et al. (2011) and Hasnan et al. (2016).

With respect to the ownership, the results are not surprising and show that ownership structure of listed firms in Malaysia is highly concentrated. On average, the percentage of ownership belonged to the controlling shareholders (CSOWN) that ranged between

0% to 85.5% with a mean of 38.7%. More than 50% of the controlling shareholders (CSTYPE) were individuals or family groups. The results indicate that the majority of Malaysian firms are controlled by families (Claessens et al., 2000; Munir et al., 2013). These findings are consistent with Rahmat and Ali (2016), who investigated a sample of 423 listed firms in East Asia over the period of 2008-2010. They argued that at this level of ownership, controlling shareholders may carry out activities that are detrimental to the interest of minority shareholders (Claessens et al., 2000; Young et al., 2008). The level of managerial ownership (MOWN) was low with the mean (median) of 10.9% (4.5%), minimum and maximum amount of 0% and 74.4% respectively. This is in line with the findings reported by Abdul Wahab et al. (2011) who studied 448 firm-year sample of companies listed on Bursa Malaysia from 2005 to 2007.

5.3 Diagnostic Tests

This section discusses the diagnostic tests performed on the data employed in this study. It is important to conduct diagnostic tests to ensure that all regression analysis assumptions are met. Specifically, all variables were assessed in terms of:

- (i) normality;
- (ii) extreme outlier;
- (iii) multicollinearity; and
- (iv) heteroskedasticity.

5.3.1 Normality

The normality assumption can be checked with graphical methods (e.g. histogram, boxplot and Q-Q plot) and statistical tests (e.g. Shapiro-Wilk, Kolmogorov-

Smirnov and Jarque-Bera). Using both approaches, this study revealed that not all variables are normally distributed. Therefore, some corrections to the continuous variables were made by using winsorizing technique and log to deal with the normality problem.

5.3.2 Outlier

It is essential to check for any possible outliers since linear regression is sensitive to outlier effects. For this study, outliers were detected by checking the skewness value. The test shows that most of variables used in this study were strongly skewed. To limit the influence of outliers, all continuous variables were winsorised at the 1st and 99th percentile. This procedure is in line with other studies in RPTs such as Jian and Wong (2004), Kohlbeck and Mayhew (2010), Rahmat and Ali (2016) and Wong et al. (2015). Study by Leone et al. (2012) provided evidence that 63% (532 out of 851 studies) of the accounting research used winsorising approach to deal with outliers, suggesting that it is a normal procedure in accounting studies.

5.3.3 Multicollinearity

Multicollinearity arises when at least two highly correlated independent variables are evaluated simultaneously in a regression model. The failure to identify multicollinearity could result in ambiguous interpretations of the regression results. This study used Pearson Correlation Matrix to investigate multicollinearity problem. As suggested by Farrar and Glauber (1967), a correlation coefficient greater than 0.8 indicates a potentially harmful collinear relationship.

Table 5.2 presents a Pearson's Correlation Matrix among all independent variables included in the ROA model. The findings show a strong positive correlation between RPTs and RPTRP (0.785) and between RPTs and RPTRE (0.667). However, it should be noted that all regression analyses were performed separately for RPTs variables, hence there is no issue of multicollinearity. The correlation with other variables was below 0.50. The results indicate that since the correlation coefficient was less than 0.80, there is therefore no multicollinearity problem among independent variables (Farrar & Glauber, 1967).

Further, it is argued that the correlation matrix is not enough to detect the severity of multicollinearity in an ordinary least squares regression analysis. As suggested by Gujarati (2003) and Hair et al. (2006), this study performed the Variance Inflation Factor (VIF) as another collinearity diagnostic test. VIF is a measure of the effect of other predictor variables on the standard error of a regression coefficient. The rule of thumb states that if the VIF value exceeds 10 in a given variable, then the variable is considered highly collinear (Gujarati, 2003; Hair et al., 2006). The VIF results (Appendix D) reveal that none of the VIF value was higher than 10, which indicates that all Models in this study are free from multicollinearity problems and hence, these independent variables can be fitted into one regression model.

Table 5.2

Pearson Correlation Coefficients between Independent Variables (n=300)

	1	2	3	4	5	6	7	8	9	10	11	12	13
RPTs	1												
RPTRE	0.667***	1											
RPTRP	0.785***	0.062	1										
INEDPROP	-0.053	-0.036	-0.041	1									
INEDFUNK	0.009	-0.002	0.014	-0.197***	1								
INEDSPEK	-0.012	-0.015	-0.003	0.002	-0.094	1							
INEDNET	0.045	0.04	0.03	-0.100	0.060	0.053	1						
BIG4	0.031	0.050	-0.001	-0.012	-0.061	0.118**	0.224***	1					
BSIZE	0.044	0.045	0.022	-0.372***	-0.139**	-0.005	0.172***	0.177***	1				
FSIZE	0.026	0.077	-0.029	-0.066	-0.153***	-0.036	0.260***	0.392***	0.383***	1			
LEV	-0.017	-0.022	-0.004	-0.008	-0.070	-0.078	0.160***	0.051	0.077	0.251***	1		
CSOWN	0.156***	0.055	0.163***	-0.152***	0.051	0.041	-0.020	0.079	0.019	0.094	-0.033	1	
CSTYPE	-0.179***	-0.161***	-0.106*	-0.018	0.032	-0.022	-0.022	-0.207***	-0.181***	-0.294***	-0.030	0.0945	1
MOWN	-0.040	-0.033	-0.026	-0.145**	0.079	0.022	-0.007	-0.116**	-0.061	-0.219***	-0.111***	0.0335	0.448***

Notes: RPTs = the sum of the monetary values of RPTs scaled by the total assets; RPTRE = the sum of the monetary values of RPTRE scaled by the total assets; RPTRP = the sum of the monetary values of RPTRP scaled by the total assets; INEDPROP = total number of INEDs divided by total number of directors; INEDFUNK = total number of INEDs with financial expertise divided by total number of INEDs; INEDSPEK = INEDs' tenure divided by total number of INEDs; INEDNET = INEDs' directorships divided by total number of INEDs; BIG4 is a dummy variable coded 1 if the firm is audited by Big 4, and 0 otherwise; BSIZE = total number of directors on the board; FSIZE is natural log of total assets of the firm; LEV = total debt divided by total assets; CSOWN is the percentage of shares owned by controlling shareholder; CSTYPE is a dummy variable coded 1 if the controlling shareholder is individual or group of family and 0 otherwise; MOWN is the percentage of shares owned by management."

Significant at *** $p < 0.01$, ** $p < 0.05$, * $p < 0.10$.

5.3.4 Heteroscedasticity Test

Homoscedasticity is another assumption that needs to be considered in performing the multiple regression test. The assumption states that the variance around the regression line is the same across all values of the independent variables. Heteroscedasticity (the violation of homoscedasticity) is presented when the size of the error term differs across values of an independent variable. It is argued that ignoring the presence of heteroscedasticity can result in inefficient coefficient estimations and biased standard errors (Baltagi, 2015). The presence of heteroscedasticity was tested using White's (1980) procedure suggested by Gujarati (2003). The results (unreported) show that all ROA models in this study are free from heteroscedasticity problem.

5.4 Multiple Regression Results

The relationship between RPTs and firm performance as well as moderating variables of the proportion of INEDs and INEDs' HC and SC was estimated using Ordinary Least Square (OLS). Ten regressions were conducted to test the hypotheses of this study. First, the results of the direct relationship between RPTs and firm performance are shown in Table 5.3. Second, this study reran the analysis by categorizing RPTs into types of related parties. The results are shown in Table 5.3a. Third, the results of the moderating effects of the proportion of INEDs and their HC and SC (including INEDs' functional knowledge, firm-specific knowledge and external networking) on the relationship between RPTs and firm performance are displayed in Tables 5.4 to 5.7. Finally, this study reran the moderated multiple regression analysis, using types of related parties as independent variables and the results are shown in Tables 5.4a to 5.7a.

As suggested by Aiken and West (1991), the direct terms used to construct interaction terms in this study were mean centered to avoid the problem of high multicollinearity between the predictor variables and the interaction terms. The Variance Inflation Factor (VIF) tests were performed to detect multicollinearity. The results reveal that none of the VIF value was higher than 10, which indicates that all Models in this study are free from multicollinearity problems (Appendix D). Furthermore, the results of White's test show all models are free from heteroscedasticity problems.

5.4.1 Related Party Transactions and Firm Performance

This section discusses the regressions results highlighting the relationship between the dependent variable (ROA) and independent variables (RPTs). All control variables (i.e. BIG4, BSIZE, FSIZE, LEV, CSOWN, CSTYPE, MOWN and INDUSTRY) which might have an influence on firm performance were also included in the regression.

Table 5.3 provides the regression results of the relationship between RPTs and firm performance (ROA). F-statistics for this model was significant at the level of $p < 0.01$. The adjusted R^2 was 0.104 which indicates that approximately 10% of the variation in the dependent variable (ROA) is explained by the variables of interest. The result shows that, overall, RPTs have a positive effect on firm performance, as measured by ROA. The coefficient was 0.069 ($t=2.189$) and is significant at the level of $p < 0.05$. The positive coefficient of RPTs indicates that firms with higher value of RPTs are associated with higher firm performance, thus Hypothesis 1 which predicts a negative relationship is not supported. The result suggests that in Malaysia, most of RPTs are

conducted for efficiency reasons, thus supporting the value-enhancing view (i.e. efficient transaction hypothesis) of RPTs.

The coefficient of control variables, FSIZE (0.013) and CSOWN (0.072) were positively associated with ROA and significant at level $p < 0.01$ and $p < 0.05$ respectively. The coefficient of LEV was negative (-0.121) and significant at level $p < 0.01$. Other control variables (BIG4, BSIZE, CSTYPE and MOWN) were not significant.

Table 5.3
Regression Results for the Effect of RPTs on Firm Performance

Variable	ROA	
	Std. Coeff.	t-Stat
Constant	-0.190	-2.139**
RPTs	0.069	2.189**
BIG4	-0.010	-0.880
BSIZE	0.001	0.164
FSIZE	0.013	2.805***
LEV	-0.121	-4.526***
CSOWN	0.072	2.456**
CSTYPE	-0.008	-0.580
MOWN	0.014	0.355
INDUSTRY	Included	
Adjusted R-squared	0.104	
F-statistic	3.489***	
Observations	300	

Notes: ROA = net profit divided by total assets; RPTs = the sum of the monetary values of RPTs scaled by the total assets; BIG4 is a dummy variable coded 1 if the firm is audited by Big 4, and 0 otherwise; BSIZE = total number of directors on the board; FSIZE is natural log of total assets of the firm; LEV = total debt divided by total assets; CSOWN is the percentage of shares owned by controlling shareholder; CSTYPE is a dummy variable coded 1 if the controlling shareholder is individual or group of family and 0 otherwise; MOWN is the percentage of shares owned by management. Industry effects are included but not reported for brevity.

***, **, * indicate significance at the 0.01, 0.05 and 0.10 level, respectively.

Additional regressions analyses classifying RPTs into transactions with related entities and transactions with related person were conducted to examine whether the effect of RPTs on firm performance may vary depending on the particular parties involving in

the transactions. As shown in Table 5.3a, the adjusted R^2 was 0.106 which indicates that approximately 11% of the variation in the dependent variable (ROA) is explained by the variations in the variables of interest.

Regression result in Table 5.3a shows that the coefficient of the RPTRE was positive (1.118) and significant at level $p < 0.05$. The positive relationship implies that RPTs with subsidiaries, associates and joint ventures increases firm performance, which suggests accepting the Hypothesis 1a. This finding gives support to the value-enhancing view of RPTs. The result suggests that RPTRE is a major attribute contributing to the positive relationship between RPTs and firm performance.

However, as shown in Table 5.3a, this study did not find any relationship between RPTRP (transactions involving director; major shareholder; person connected with director or major shareholder or director related entities) and firm performance. The result suggests rejecting the Hypothesis 1b which proposes a negative relationship between RPTRP and firm performance.

Table 5.3a also shows that the relationships between control variables and ROA were consistent with the base model in Table 5.3. The coefficient of FSIZE (0.013) and CSOWN (0.074) was positive and significant at level $p < 0.01$ and $p < 0.05$ respectively. The coefficient of LEV was negative (-0.120) and significant at level $p < 0.01$. Other control variables (BIG4, BSIZE, CSTYPE and MOWN) were not significant in both models.

Table 5.3a

Regression Results for the Effect of RPTs (based on types of Related Parties) on Firm Performance

Variable	ROA	
	Std. Coeff.	t-Stat
Constant	-0.187	-2.107**
RPTRE	0.118	2.393**
RPTRP	0.033	0.791
BIG4	-0.010	-0.878
BSIZE	0.001	0.180
FSIZE	0.013	2.728***
LEV	-0.120	-4.503***
CSOWN	0.074	2.535**
CSTYPE	-0.007	-0.531
MOWN	0.013	0.324
Industry	Included	
Adjusted R-squared	0.106	
F-statistic	3.376***	
Observations	300	

Notes: ROA = net profit divided by total assets; RPTRE = the sum of the monetary values of RPTRE scaled by the total assets; RPTRP = the sum of the monetary values of RPTRP scaled by the total assets; BIG4 is a dummy variable coded 1 if the firm is audited by Big 4, and 0 otherwise; BSIZE = total number of directors on the board; FSIZE is natural log of total assets of the firm; LEV = total debt divided by total assets; CSOWN is the percentage of shares owned by controlling shareholder; CSTYPE is a dummy variable coded 1 if the controlling shareholder is individual or group of family and 0 otherwise; MOWN is the percentage of shares owned by management. Industry effects are included but not reported for brevity.

***, **, * indicate significance at the 0.01, 0.05 and 0.10 level, respectively.

Discussion of Results

The first objective of this study is to provide evidence concerning the effect of RPTs on firm performance. A few conclusions can be drawn from the results of this study. First, this study provides evidence that, on average, RPTs are not harmful to minority shareholders. Specifically, the results indicate that in general, RPTs have a positive effect on firm performance. The positive effect implies that a firm with higher RPTs have a higher firm performance, and thus supports the value-enhancing view (i.e. efficient transaction hypothesis) of RPTs. The findings support Wong et al. (2015)

who suggested that RPTs are generally used for efficiency reasons. In the Malaysian context, the results are in line with Hasnan, Abdul Rahman and Mahenthiran (2013). Hasnan et al. (2013) provided evidence that firms with higher RPTs are negatively related to the likelihood of fraudulent financial statements. However, the findings contradict earlier findings of Abdul Wahab et al. (2011), Hasnan et al. (2016) and Munir et al. (2013) who documented that RPTs negatively affect firm performance.

Second, this study provided evidence that transactions with different types of related parties affect firm performance differently. Specifically, the results show a positive relationship between RPTRE and firm performance, thus giving support to the view that transactions that involve subsidiaries, associates and joint ventures are considered as efficient transaction that may not have expropriation effect. The findings are consistent with Khanna and Palepu (2000) who found that firms affiliated with diversified business groups perform better than unaffiliated firms, suggesting the potential benefits of business group in emerging countries where capital market does not function well. Khanna and Palepu (2000) argued that the intra-business group transactions (i.e. RPTs) can help the firm to optimize internal resource allocation and to reduce transaction cost.

However, the results for RPTRP (transactions with director, major shareholder, person connected with director or major shareholder or director related entities) are not significant. The possible explanation for these results is that the RPTRP might be used by insiders as a mechanism to reduce transaction costs and to increase the efficiency of resource allocation (Khanna & Palepu, 2000; Utama et al., 2010). However, due to risk associated with RPTs, these transactions might also be used to expropriate

minority shareholders' wealth. Therefore, in light of the insignificant effect of RPTRP on firm performance, the efficiency effect of RPTRP appears to outweigh the expropriation effect, but not large enough effect to be significant. The result is consistent with the argument by Utama et al. (2010) that in a country where external markets are inefficient, the potential expropriate effects of RPTs do not necessarily offset the potential beneficial effects of RPTs. In sum, findings from this study indicate that the effect of RPTs on firm performance is contingent on the types of parties involved in the transactions (Jian & Wong, 2010; Kohlbeck & Mayhew, 2010; Nekhili & Cherif, 2011).

The positive relationship between RPTs and firm performance found in this study may be partly explained by the many reforms to the laws, regulations and guidelines since year 2000, attempting to reduce the prevalent of abusive RPTs in Malaysia. It is evident by the survey conducted by World Bank in 2013 which show that Malaysia ranks 4th out of 183 economies with a score of 8.7 on the strength of investor protection against directors' misuse of corporate assets (World Bank, 2013). The survey gauge three dimensions of investor protections, which include transparency of RPTs, liability for self-dealing and shareholders' ability to sue officers and directors for misconduct. In addition, a survey conducted by the World Economic Forum revealed that Malaysia scores 5.2 out of seven for the protection of minority shareholders' interests by the legal system – placing it 15th out of 144 countries (World Economic Forum, 2013). The higher score indicates that Malaysia regulations offer stronger investor protections against abusive RPTs and this may possibly explain the positive findings of this study.

Furthermore, as argued by Khanna and Palepu (2000) and Utama et al. (2010), in countries with imperfect markets like Malaysia, RPTs may have to be conducted given costly external markets. Furthermore, Malaysia's economy is characterized by a relationship-based system and RPTs are therefore a common business deal among Malaysian companies. A substantial number of Malaysian listed companies belong to large business groups and it is therefore common that RPTs become part of every business group activity. According to OECD (2009), in many cases RPTs are perceived as being inevitable, useful and recurring in ongoing operations.

5.4.2 Moderating Effect of the Proportion of INEDS on the Relationship between RPTs and Firm Performance

Hypotheses H2, H2a and H2b predicted a positive moderating effect of the proportion of INEDs on the relationship between RPTs (total RPTs and types of related parties) and firm performance. In other words, the presence of higher number of INEDs on the boards is anticipated to weaken the negative (and strengthen the positive) effect of RPTs on firm performance.

As shown in Table 5.4, all interaction terms between RPTs and the proportion of INEDs ($RPTs*INEDPROP$, $RPTRE*INEDPROP$ and $RPTRP*INEDPROP$) were not significant, which indicates that H2, H2a and H2b are not empirically supported. Therefore, this study does not provide support for the agency theory in terms of the moderating effect of the proportion of INEDs on the RPTs-firm performance relationship.

For the control variables, results shown in Table 5.6 are consistent with the base model in Table 5.3. The coefficient of FSIZE and CSOWN was positive and significant at level $p < 0.01$ and $p < 0.05$ respectively. The coefficient of LEV was negative and significant at level $p < 0.01$. Other control variables (BIG4, BSIZE, CSTYPE and MOWN) were not significant.

Table 5.4
Regression Results for the Moderating Effect of the Proportion of INEDs on RPTs - Firm Performance Relationship

Variable	ROA			
	Total RPTs		Types of Related Parties	
	Std. Coeff	t-Stat	Std. Coeff	t-Stat
Constant	-0.203	-2.176**	-0.200	-2.142**
RPTs	0.070	2.202**		
RPTRE			0.127	2.516**
RPTRP			0.029	0.687
INEDPROP	0.023	0.465	0.018	0.350
BIG4	-0.011	-0.897	-0.011	-0.877
BSIZE	0.001	0.311	0.001	0.241
FSIZE	0.013	2.761***	0.013	2.721***
LEV	-0.121	-4.492***	-0.119	-4.403***
CSOWN	0.073	2.453**	0.077	2.573**
CSTYPE	-0.008	-0.579	-0.007	-0.504
MOWN	0.017	0.421	0.014	0.345
RPTs*INEDPROP	0.060	0.230		
RPTRE*INEDPROP			0.336	0.830
RPTRP*INEDPROP			-0.208	-0.500
Industry		Included		Included
Adjusted R-squared		0.100		0.100
F-statistic		3.052***		2.852***
Observations		300		300

Notes: ROA = net profit divided by total assets; RPTs = the sum of the monetary values of RPTs scaled by the total assets; RPTRE = the sum of the monetary values of RPTRE scaled by the total assets; RPTRP = the sum of the monetary values of RPTRP scaled by the total assets; INEDPROP = total number of INEDs divided by total number of directors; BIG4 is a dummy variable coded 1 if the firm is audited by Big 4, and 0 otherwise; BSIZE = total number of directors on the board; FSIZE is natural log of total assets of the firm; LEV = total debt divided by total assets; CSOWN is the percentage of shares owned by controlling shareholder; CSTYPE is a dummy variable coded 1 if the controlling shareholder is individual or group of family and 0 otherwise; MOWN is the percentage of shares owned by management. Industry effects are included but not reported for brevity.

***, **, * indicate significance at the 0.01, 0.05 and 0.10 level, respectively.

Discussion of Results

The second objective of this paper is to provide evidence on the moderating effect of the proportion of INEDs on the relationship between RPTs (total RPTs and types of related parties) and firm performance. Contrary to expectation, this study documented that the proportion of INEDs does not moderate the RPTs-firm performance relationship, suggesting that greater representation of INEDs on the board does not necessarily allow the board to more effectively monitor RPTs. The results contradict earlier findings of Abdul Wahab et al. (2011) who found that INEDs, due to their independence, can better monitor RPTs and thus mitigating the negative effect of RPTs on firm performance. The results therefore do not provide support for the agency theory.

There are four possible explanations for the insignificant results. First, the results for the direct relationship between RPTs and firm performance suggest that in general, RPTs in Malaysia are efficient transactions. Therefore, according to Gordon et al. (2004), if RPTs are efficient transactions, “there would be no need to increase monitoring” (p. 3), and thus, there would be no interaction effect between RPTs and the proportion of INEDs.

Second, Gordon et al. (2004) also argued that, “even if RPTs are efficient transactions, a company can choose to increase monitoring to avoid the appearance of conflict of interest” (p. 3). The insignificant moderating effect of the proportion of INEDs on RPTs-firm performance relationship may indicate that their presence on corporate board does not improve corporate governance and is therefore not considered as an effective monitoring mechanism. This insignificant finding is consistent with the

argument by Abdullah, Ku Ismail and Nachum (2015) that Malaysia, like other emerging countries, INEDs are “a concept deprived of its actual meaning”. The mere presence of INEDs does not mean that they can serve an effective governance role. Their value as corporate monitor and corporate advisor may diminish as they may only play a symbolic role rather than having more influence in monitoring and advising the decision making of insiders to enter into RPTs.

Third, the insignificant results may also be explained from the perspective of the institutional theory that INEDs are appointed due to external institutional pressure such as pressure from government regulations and corporate governance reforms (Kim, 2007; Peng, 2004). According to Abdullah et al. (2015), there is a possibility that firms in Malaysia appoint INEDs to just meet the legal definition of independence but the INEDs are close to the management and act primarily in the interest of the insiders. Therefore, the presence of higher number of INEDs in the boardroom may not necessarily improve the quality of firms’ corporate governance. This is consistent with the argument by DiMaggio and Powell (1983) that “structural change in organizations seems less and less driven by competition or by the need for efficiency...organization change occurs as a result of the process that makes organizations more similar without necessarily making them more efficient” (p. 147).

Fourth, the effectiveness of INEDs may be hindered by their lack of specific information. As outsiders, INEDs may be constrained in terms of information and they are therefore considered as less-informed as compared to inside directors. They depend largely on the CEOs and management to provide them with sound information (Lin, 2013). However, the powerful CEOs (in the case when moral hazard problems

arise because the RPTs' motive differs from those of the shareholders) would be hesitant to share firm-specific information with INEDs because with their greater presence on the board, they may be able to monitor CEOs more intensely. This is consistent with the argument by Adam and Ferreira (2007) that although greater representation of INEDs on the board increases monitoring incentives, it also reduces the CEOs' willingness to share information. Therefore, the cost for INEDs to become informed may offset their monitoring advantages.

5.4.3 Moderating Effects of INEDs' Human Capital and Social Capital on the Relationship between RPTs and Firm Performance

The focus of this study is to examine the moderating effects of INEDs' HC (measured by INEDs' functional knowledge in accounting and finance, INEDs' firm-specific knowledge) and INEDs' SC (measured by INEDs' external networking) on the relationship between RPTs and firm performance. Tables 5.5 to 5.7 provide the moderated regression results. F-statistics for all models was significant at the level $p < 0.01$.

5.4.3.1 INEDs' Functional Knowledge in Accounting and Finance

Hypotheses H3, H3a and H3b predicted a moderating effect of INEDs' functional knowledge in accounting and finance on the relationship between RPTs (total RPTs and types of related parties) and firm performance. To be more specific, this study postulated that the greater the ratio of INEDs' functional knowledge, the stronger (weaker) the positive (negative) relationship between RPTs and firm performance. As shown in Table 5.5, the interaction terms of RPTs variables with INEDs' functional knowledge (RPTs*INEDFUNK, RPTRE*INEDFUNK and RPTRP*INEDFUNK)

were not significant. The findings are not in line with the predictions, and thus H3, H3a and H3b are rejected. This means that INEDs' functional knowledge does not play a positive role in enhancing the ability of INEDs to perform their monitoring and advising roles relating to RPTs. This study therefore does not provide support for the resource dependence, human capital and social capital theories in terms of the moderating effect of INEDs' functional knowledge in accounting and finance on the RPTs-firm performance relationship.

This is consistent with Persons (2005) that there are two possible explanations for the insignificant findings. First, due to time constraints, INEDs, as part time board members, may spend relatively short time reviewing RPTs proposal. Therefore, it may be impossible that even INEDs with knowledge in accounting and finance can provide sound recommendations to management and effectively monitor them. Second, the presence of more INEDs with financial expertise on the board raises a free rider problem. In this situation, each INED views the importance of his or her contribution as being reduced, therefore, leading him or her to become less vigilant. These two factors may offset the expertise and advising benefit by INEDs.

Table 5.5

Regression Results for the Moderating Effect of INEDs' Functional Knowledge in Accounting and Finance on RPTs - Firm Performance Relationship

Variable	Total RPTs		Types of Related Parties	
	Std. Coeff	t-Stat	Std. Coeff	t-Stat
Constant	-0.184	-2.033**	-0.181	-1.991**
RPTs	0.071	2.262**		
RPTRE			0.119	2.403**
RPTRP			0.039	0.916
INEDFUNK	-0.005	-0.242	-0.005	-0.229
BIG4	-0.010	-0.881	-0.011	-0.889
BSIZE	0.000	0.026	0.000	0.049
FSIZE	0.013	2.806***	0.013	2.712***
LEV	-0.121	-4.538***	-0.122	-4.547***
CSOWN	0.073	2.481**	0.074	2.529**
CSTYPE	-0.006	-0.459	-0.005	-0.372
MOWN	0.007	0.182	0.006	0.147
RPTs*INEDFUNK	-0.180	-1.323		
RPTRE*INEDFUNK			-0.067	-0.311
RPTRP*INEDFUNK			-0.252	-1.433
Industry	Included		Included	
Adjusted R-squared	0.104		0.104	
F-statistic	3.160***		2.925***	
Observations	300		300	

Notes: ROA = net profit divided by total assets; RPTs = the sum of the monetary values of RPTs scaled by the total assets; RPTRE = the sum of the monetary values of RPTRE scaled by the total assets; RPTRP = the sum of the monetary values of RPTRP scaled by the total assets; INEDFUNK = total number of INEDs with financial expertise divided by total number of INEDs; BIG4 is a dummy variable coded 1 if the firm is audited by Big 4, and 0 otherwise; BSIZE = total number of directors on the board; FSIZE is natural log of total assets of the firm; LEV = total debt divided by total assets; CSOWN is the percentage of shares owned by controlling shareholder; CSTYPE is a dummy variable coded 1 if the controlling shareholder is individual or group of family and 0 otherwise; MOWN is the percentage of shares owned by management. Industry effects are included but not reported for brevity.

***, **, * indicate significance at the 0.01, 0.05 and 0.10 level, respectively.

5.4.3.2 INEDs' Firm-Specific Knowledge

Hypotheses H4, H4a and H4b predicted a moderating effect of INEDs' firm-specific knowledge on the relationship between RPTs (total RPTs and types of related parties) and firm performance. This study specifically postulated that INEDs with high levels of firm-specific knowledge strengthen (weaken) the positive (negative) relationship between RPTs and firm.

As shown in Table 5.6, the interaction between RPTs variables and INEDs' firm-specific knowledge (RPTs*INEDSPEK, RPTRE*INEDSPEK and RPTRE*INEDSPEK) were not significant, which indicates that H4, H4a and H4b are not empirically supported. Therefore, this study does not provide support for the resource dependence, human capital and social capital theories in terms of the moderating effect of INEDs' firm-specific knowledge on the RPTs-firm performance relationship. This means that the importance of INEDs' tenure as a source of firm-specific knowledge, internal network and reputation, which may enhance their ability to be effective monitors and advisors, is not supported.

There are two possible explanations for the insignificant result. First, INEDs may face trade-off between knowledge accumulation and entrenchment effects, as suggested by Huang (2013). INEDs develop more firm-specific knowledge as their tenure increases, which in turn leads to effective monitoring and advising roles. Increased familiarity between INEDs and the insiders can however undermine their independence (Hwang & Kim, 2009), which can reduce their monitoring and advising abilities. Therefore, some scholars suggest a non-linear relationship between INEDs'

firm-specific knowledge and their independence (Brown et al., 2017). Additional analysis is conducted in Section 5.4.3.6 to examine this notion.

Second, the insignificant results may indicate that firm-specific knowledge as measured by INEDs' tenure does not matter in the execution of monitoring roles by INEDs or the proxy used to capture firm-specific knowledge may not really capture that knowledge, as suggested by Kamardin and Haron (2011).

Table 5.6
Regression Results for the Moderating Effect of INEDs' Firm-Specific Knowledge on RPTs – Firm Performance Relationship

Variable	Total RPTs		Types of Related Parties	
	Std. Coeff	t-Stat	Std. Coeff	t-Stat
Constant	-0.191	-2.140**	-0.183	-2.045**
RPTs	0.071	2.254**		
RPTRE			0.119	2.398**
RPTRP			0.036	0.867
INEDSPEK	-0.001	-0.459	-0.001	-0.709
BIG4	-0.011	-0.929	-0.011	-0.933
BSIZE	0.000	0.115	0.000	0.067
FSIZE	0.014	2.870***	0.013	2.787***
LEV	-0.123	-4.578***	-0.124	-4.616***
CSOWN	0.072	2.454**	0.076	2.576**
CSTYPE	-0.007	-0.545	-0.007	-0.548
MOWN	0.016	0.392	0.015	0.366
RPTs*INEDSPEK	0.007	0.956		
RPTRE*INEDSPEK			-0.010	-0.631
RPTRP*INEDSPEK			0.015	1.528
Industry	Included		Included	
Adjusted R-squared	0.101		0.105	
F-statistic	3.110***		2.953***	
Observations	300		300	

Table 5.6 (continued)

Notes: ROA = net profit divided by total assets; RPTs = the sum of the monetary values of RPTs scaled by the total assets; RPTRE = the sum of the monetary values of RPTRE scaled by the total assets; RPTRP = the sum of the monetary values of RPTRP scaled by the total assets; INEDSPEK = INEDs' tenure divided by total number of INEDs; BIG4 is a dummy variable coded 1 if the firm is audited by Big 4, and 0 otherwise; BSIZE = total number of directors on the board; FSIZE is natural log of total assets of the firm; LEV = total debt divided by total assets; CSOWN is the percentage of shares owned by controlling shareholder; CSTYPE is a dummy variable coded 1 if the controlling shareholder is individual or group of family and 0 otherwise; MOWN is the percentage of shares owned by management. Industry effects are included but not reported for brevity

***, **, * indicate significance at the 0.01, 0.05 and 0.10 level, respectively.

5.4.3.3 INEDs' External Networking

Hypotheses H5, H5a and H5b predicted that INEDs' external networking moderates the relationship between RPTs (total RPTs and types of related parties) and firm performance. Table 5.7 shows that the all the interaction terms of RPTs variables with INEDs' external networking (RPTs*INEDNET, RPTRE*INEDNET and RPTRP*INEDNET) were not significant. Therefore, H5, H5a and H5b were not empirically supported, suggesting that INEDs' firm-specific knowledge does not necessarily improve INEDs' ability to perform their monitoring and advice-giving functions.

The insignificant findings may be attributable to the potential tradeoffs between the costs and benefits of INEDs' external networking, which in turn compromise the ability of INEDs to effectively represent the interests of the shareholders. Serving on multiple boards may signal superior quality of such directors (Fama, 1980; Vafeas, 1999) and provide the directors with valuable sources of knowledge and information on different management skills and business network contacts, which could enable them to enhance board functions as well as shareholder value (Mace, 1986). On the other hand, being appointed to multiple boards could undermine the effectiveness of

INEDs in scrutinizing managerial activities due to time constraints (Fich & Shivdasani, 2006). Therefore, lack of time may counteract the benefits of INEDs' external networking and this may possibly explain the insignificant findings of this study.

Table 5.7

Regression Results for the Moderating Effect of INEDs' External Networking on RPTs - Firm Performance Relationship

Variable	Total RPTs		Types of Related Parties	
	Std. Coeff	t-Stat	Std. Coeff	t-Stat
Constant	-0.194	-2.162**	-0.205	-2.185**
RPTs	0.071	2.220**		
RPTRE			0.125	2.468**
RPTRP			0.035	0.827
INEDNET	-0.002	-0.393	-0.002	-0.367
BIG4	-0.010	-0.799	-0.010	-0.809
BSIZE	0.001	0.175	0.001	0.336
FSIZE	0.014	2.819***	0.013	2.692***
LEV	-0.120	-4.447***	-0.118	-4.365***
CSOWN	0.072	2.431**	0.076	2.548**
CSTYPE	-0.007	-0.555	-0.007	-0.551
MOWN	0.015	0.376	0.017	0.428
RPTs*INEDNET	-0.009	-0.295		
RPTRE*INEDNET			-0.032	-0.645
RPTRP*INEDNET			0.000	0.005
Industry	Included		Included	
Adjusted R-squared	0.100		0.100	
F-statistic	3.047***		2.675***	
Observations	300		300	

Notes: ROA = net profit divided by total assets; RPTs = the sum of the monetary values of RPTs scaled by the total assets; RPTRE = the sum of the monetary values of RPTRE scaled by the total assets; RPTRP = the sum of the monetary values of RPTRP scaled by the total assets; INEDNET = INEDs' directorships divided by total number of INEDs; BIG4 is a dummy variable coded 1 if the firm is audited by Big 4, and 0 otherwise; BSIZE = total number of directors on the board; FSIZE is natural log of total assets of the firm; LEV = total debt divided by total assets; CSOWN is the percentage of shares owned by controlling shareholder; CSTYPE is a dummy variable coded 1 if the controlling shareholder is individual or group of family and 0 otherwise; MOWN is the percentage of shares owned by management. Industry effects are included but not reported for brevity

***, **, * indicate significance at the 0.01, 0.05 and 0.10 level, respectively.

Discussion of Results

The third and fourth objectives of this paper are to provide evidence on the moderating effects of INEDs' HC and SC on the relationship between RPTs and firm performance. In this study, INEDs' HC are measured by the percentage of INEDs' financial expertise and average tenure of INEDs, while INEDs' SC is measured by the average number of INEDs' directorships in other firms. The results in Tables 5.5 to 5.7 pertain to Hypotheses 3, 3a, 3b, 4, 4a, 4b, 5, 5a, and 5b, which predicted the moderating effects of INEDs' HC (i.e. functional-knowledge and firm-specific knowledge) and INEDs' SC (i.e. external networking) on RPTs-firm performance relationships. The findings indicate that there is an overall lack of meaningful evidence to support the hypotheses that INEDs' HC and SC positively moderate the RPTs-firm performance relationships. This study does not specifically find support for the moderating effects of INEDs' functional knowledge in accounting and finance, INEDs' firm-specific knowledge and INEDs' external networking. Thus, Hypotheses 3, 3a, 3b, 4, 4a, 4b, 5, 5a, and 5b are not empirically supported.

The insignificant moderating effects of INEDs' HC and SC on RPTs-firm performance relationship indicate that their financial expertise, firm-specific knowledge and external networking do not appear to make a difference to their effectiveness in monitoring and advising management and controlling shareholders. The results are contrary to the arguments of the resource dependence, human capital and social capital theories. The theories suggest that INEDs with high level of HC and SC, indicated by being expert in accounting/finance, having long-term experience as INEDs and having external networking, can provide effective monitoring and advising (Hillman & Dalziel, 2003; de Villiers et al., 2011). The theories argue that INEDs, equipped with

financial expertise, firm-specific knowledge and external networking, are considered to be more experienced and knowledgeable in accounting/finance issues such as RPTs, be more familiar about a business or industry environment, be more knowledgeable with each other's skills and personalities (Fisher & Pollock, 2004) and have more familiarity with top management. Consequently, with this knowledge and experience, they can lead a firm to engage in efficient RPTs or avoid conflict of interest transactions and can hence increase firm performance. The arguments put forward by the resource dependence, human capital and social capital theories, however, are not supported in all constructs used in this study.

There are few possible perspectives to explain the insignificant moderating effects of INEDs' HC and SC on RPTs-firm performance relationship. First, from the perspective of cognitive ability; according to the information processing theory, the individuals' ability to process information depends on his/her cognitive capabilities. Once the individuals' cognitive thresholds are reached, his/her ability to effectively process information declines (O'Reilly, 1980). Khanna et al. (2013) argued that the excessive information demands faced by directors mitigate the benefits associated with their HC. In Malaysia, INEDs are expected to perform their monitoring role by means of sitting in a number of watch-dog committees, including the audit, remuneration and nominating committees (Annuar & Abdul Rashid, 2015). They also sit on the board of various firms. The substantive involvement of INEDs in these committees and other boards requires them to process a large amount of information in order to fulfill their roles. These information processing demands may offset their ability (i.e. INED's HC) to effectively monitor and advise management (Khanna et al., 2013).

Second, from the perspective of boundary conditions; Brown et al. (2017) argued that whether executive cognition (i.e. firm-specific knowledge) and SC (i.e. internal and external networking) add value to the directors as an effective governance is restricted to boundary conditions of their tenure. There exists a dilemma between cognitive and social (or networking) aspects of directors. This means that while directors' firm-specific and industry knowledge increases over time, the ability and independence of directors in providing effective monitoring and advising may be offset as they become under the influence of management. Brown et al. (2017) suggested a curvilinear relationship between the value of directors and their tenure and therefore, there exists a period that they referred as "prime tenure period" when directors are considered most valuable to shareholders. Early in their tenure, the ability of directors to be effective monitor is limited due to their "knowledge-deficit" and lack potential benefits of internal and external SC. Once they reach this prime period of tenure, directors are considered to have enough cognition and SC to provide value to their focal firm. However, when the tenure increased beyond the prime period, the value of directors begins to decrease. The insignificant moderating effect of INEDs' tenure found in this study may imply that the tenure of most INEDs may not be within the parameter of the "prime period" as suggested by Brown et al. (2017).

Third, from the information asymmetries perspective; Lin (2013) argued that because INEDs are not full-time directors and are not involved in the operational and management aspects of the company, they face information asymmetries that may hamper their decision-making process. Even though INEDs with higher level of HC and SC are expected to be knowledgeable and have easy access to information, they still have to rely on the management of the focal firm to provide them with more sound

information (Lin, 2013). There is a tendency that the management would conceal certain information on RPTs if they are designed and conducted to extract wealth from the firm. Without sufficient and accurate information, it is difficult for INEDs to detect illegal activities and this may diminish their ability to effectively monitor the management and controlling shareholders. Furthermore, as argued by Annuar (2011), INEDs in Malaysia may face difficulty in getting access to company information due to the national culture. Most of the family companies in Malaysia are owned by Chinese and they usually have close family ties within the family members (Amran & Che Ahmad, 2011). It appears that ethnic background of the INEDs might influence the extent of the willingness of the management to share information especially in the Chinese companies. Trust is the most important criterion in Chinese business and they do not easily trust an outsider simply because of his or her status or position. Due to this culture, management of the Chinese companies tend to become secretive in sharing information with INEDs, in turn offsetting the benefits of their HC and SC.

Fourth, from the perspective of the appointment process of INEDs and their social ties. In Malaysia, the MCCG 2000 recommended all PLCs to establish a Nominating Committee with the responsibilities of monitoring the appointment and assessment of directors. In this process, the Nominating Committee assesses the suitability of the candidates based on certain criteria such as knowledge, diversity, commitment, experience and integrity that the directors can bring to the board. However, in country with concentrated ownership structure like Malaysia, controlling shareholders can inevitably exert significant influence on the selection of INEDs (Abdullah et al., 2016). Abdullah et al. (2016) documented that the sources of INEDs in Malaysia come from inside the firms, including from the board members, CEO or controlling shareholders.

The candidates are normally those within the personal network of the insiders. This personal network or social ties between INEDs and the controlling shareholders are argued to impair the independence of INEDs and hence undermine the ability of INEDs to carry their duties objectively and effectively (Abdullah et al., 2016; Bebchuk & Hamdani, 2017; Lin, 2013; Muttakin et al., 2016). In Enron's case, for example, the majority of the board members had expertise in business, investment, and accounting, and several had sit on the board for more than twenty years (Lin, 2013). Investigation by the United States Senate revealed that several Enron's INEDs had close personal relationships with the chairman and CEO Kenneth Lay (Lin, 2013). This indicates that social tie between INEDs and the insiders can diminish the benefits of INEDs' HC and SC.

Fifth, INEDs are more likely to experience time constraints relative to the managers, thereby reducing their ability to properly evaluate the recommendations and decisions of managers (Annuar, 2011; Sharpe, 2011). As argued by Sharpe (2011), other than knowledge and information that are derived from INEDs' HC and SC, INEDs also need time for better decision making process, and for better firm performance. Organizational behavior scholars have noted that information, knowledge and time are three attributes that are critical for the success of corporate boards and the firms. According to Sharpe (2011), "Each of these three components can simultaneously be a limiting and enabling factor for board success...improve one of the components and a board is likely to perform better. Diminish one and the board will perform worse" (p. 1452). The arguments indicate that it may be difficult that even INEDs with a higher level of HC and SC can perform their oversight and advising functions if they face time constraints.

5.4.4 Additional Tests

Additional tests which include alternative measure for INEDs' firm-specific knowledge, INEDs' external networking, INEDs' HC and SC index, firm performance and curvilinear moderation regression were conducted to check the robustness of the main findings reported earlier.

5.4.4.1 Alternative Measure for INEDs' Firm-Specific Knowledge

This study used aggregate method (i.e. the average tenure of INEDs) to measure INEDs' firm-specific knowledge. Even though the aggregate approach is simple and easy to calculate, some scholars argue that it may mask the dispersion of INEDs' firm-specific knowledge (Dou et al., 2015; Vafeas, 2003). Therefore, as an alternative, the threshold level of INEDs' tenure is created to replace the aggregate approach used in the main models.

This study used a threshold level of tenure between 7 to 9 years as a prime period where directors are considered to have enough cognition and SC to provide value to their focal firm. The decision to choose 7 years as the threshold is consistent with the finding of this study that the average tenure of INEDs is around 7 years. In addition, study by Brown et al. (2017) provided evidence that INEDs are seen as the most valuable (in terms of firm-specific knowledge) when their tenure reaches 7 years. At this point, INEDs' HC and SC is at the peak level which means that they are more knowledgeable and experienced and can therefore better able to apply their HC and SC in monitoring and advising the management and controlling shareholders (Brown et al., 2017). The maximum 9 years is used in this study is to consider the tenure limit recommended by the MCCG 2012. INEDs' firm-specific knowledge is

measured as the number of INEDs with tenure between 7 to 9 years divided by the total number of INEDs.

As shown in Table 5.8, the coefficients of the interaction terms of RPTs variables with the INEDs' firm-specific knowledge except for $RPTRP*INEDSPEKPRIME$ were not significant and consistent with the main findings. The interaction term of $RPTRP*INEDSPEKPRIME$ was positive (0.218) and marginally significant at the level $p < 0.10$. This indicates that the positive relationship between transactions with related persons and firm performance becomes stronger when INEDs' tenure reaches 7 to 9 years. The results marginally support the argument by Brown et al. (2017) that there is a period when INEDs are considered to "have enough firm-specific knowledge and experience to be useful to the board, but are not yet beholden to the CEO" (p. 7).

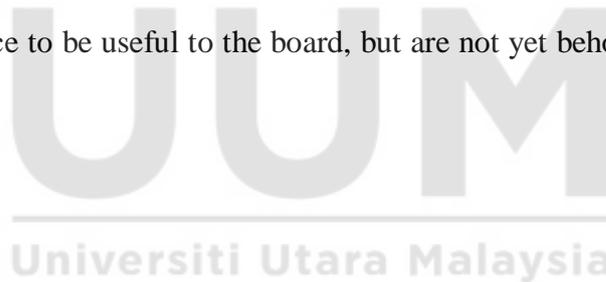
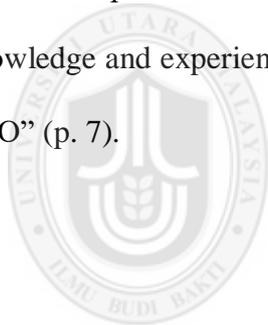


Table 5.8
Regression Results for the Moderating Effect of INEDs' Firm-Specific Knowledge (Alternative Measure) on RPTs – Firm Performance Relationship

Variable	ROA			
	Model 1		Model 2	
	Std. Coeff	t-Stat	Std. Coeff	t-Stat
Constant	-0.189	-2.12**	-0.187	-2.10**
RPTs	0.073	2.29**		
RPTRE			0.126	2.54**
RPTRP			0.037	0.88
INEDSPEKPRIME	-0.011	-0.74	-0.013	-0.88
BIG4	-0.011	-0.95	-0.011	-0.95
BSIZE	0.000	0.12	0.000	-0.01
FSIZE	0.014	2.85***	0.013	2.83***
		-		-
LEV	-0.123	4.60***	-0.124	4.64***
CSOWN	0.072	2.47**	0.077	2.61**
CSTYPE	-0.007	-0.57	-0.006	-0.50
MOWN	0.017	0.43	0.015	0.39
RPTs*INEDSPEKPRIME	0.107	1.22		
RPTRE*INEDSPEKPRIME			-0.061	-0.42
RPTRP*INEDSPEKPRIME			0.218	1.81*
Industry	Included		Included	
Adjusted R-squared	0.105		0.110	
F-statistic	3.184***		3.046***	
Observations	300		300	

Notes: ROA = net profit divided by total assets; RPTs = the sum of the monetary values of RPTs scaled by the total assets; RPTRE = the sum of the monetary values of RPTRE scaled by the total assets; RPTRP = the sum of the monetary values of RPTRP scaled by the total assets; INEDSPEKPRIME = the number of INEDs with tenure between 7 to 9 years divided by the total number of INEDs; BIG4 is a dummy variable coded 1 if the firm is audited by Big 4, and 0 otherwise; BSIZE = total number of directors on the board; FSIZE is natural log of total assets of the firm; LEV = total debt divided by total assets; CSOWN is the percentage of shares owned by controlling shareholder; CSTYPE is a dummy variable coded 1 if the controlling shareholder is individual or group of family and 0 otherwise; MOWN is the percentage of shares owned by management. Industry effects are included but not reported for brevity

***, **, * indicate significance at the 0.01, 0.05 and 0.10 level, respectively.

5.4.4.2 Alternative Measure for INEDs' External Networking

To provide robust results regarding the effect of INEDs' external networking on the RPTs-firm performance relationship, this study calculated an alternative measure of INED's external networking. The second measure is the percentage of INEDs who hold more than two outside directorships. This threshold has been widely used to measure the busyness of directors (Ferris et al., 2003; Fich & Shivdasani, 2006). However, from the perspective of board capital and quality hypothesis, INEDs who sit on multiple boards are seen as having high quality reputation (Fama, 1980; Fama & Jensen, 1983) and better external networking and experience (Hillman & Dalziel, 2003; Nahapiet & Ghoshal, 1998). As shown in Table 5.9, the interaction terms of RPTs variables with INEDs' external networking (RPTs*INEDNET2, RPTRE*INEDNET2 and RPTRP*INEDNET2) showed no significant difference with the main findings, whether INEDs' external networking is measured using average directorships or percentage of INEDs who hold more than two outside directorships. The results indicate that INEDs' external networking does not moderate the effect of RPTs on firm performance.

Table 5.9
Regression Results for the Moderating Effect of INEDs' External Networking (Alternative Measure) on RPTs – Firm Performance Relationship

Variable	ROA			
	Model 1		Model 2	
	Std. Coeff	t-Stat	Std. Coeff	t-Stat
Constant	-0.183	-2.031**	-0.181	-2.006**
RPTs	0.067	2.119**		
RPTRE			0.119	2.381**
RPTRP			0.035	0.832
INEDNET2	0.010	0.433	0.012	0.506
BIG4	-0.011	-0.944	-0.011	-0.920
BSIZE	0.001	0.173	0.000	0.142
FSIZE	0.013	2.681***	0.013	2.621***
LEV	-0.123	-4.546***	-0.120	-4.462***
CSOWN	0.071	2.399**	0.071	2.410**
CSTYPE	-0.008	-0.576	-0.007	-0.568
MOWN	0.013	0.331	0.013	0.320
RPTs*INEDNET2	0.087	0.625		
RPTRE*INEDNET2			-0.109	-0.544
RPTRP*INEDNET2			0.257	1.247
Industry	Included		Included	
Adjusted R-squared	0.100		0.103	
F-statistic	3.073***		2.910***	
Observations	300		300	

Notes: ROA = net profit divided by total assets; RPTs = the sum of the monetary values of RPTs scaled by the total assets; RPTRE = the sum of the monetary values of RPTRE scaled by the total assets; RPTRP = the sum of the monetary values of RPTRP scaled by the total assets; INEDNET2 = the number of INEDs who hold more than two directorships divided by total number of INEDs; BIG4 is a dummy variable coded 1 if the firm is audited by Big 4, and 0 otherwise; BSIZE = total number of directors on the board; FSIZE is natural log of total assets of the firm; LEV = total debt divided by total assets; CSOWN is the percentage of shares owned by controlling shareholder; CSTYPE is a dummy variable coded 1 if the controlling shareholder is individual or group of family and 0 otherwise; MOWN is the percentage of shares owned by management. Industry effects are included but not reported for brevity

***, **, * indicate significance at the 0.01, 0.05 and 0.10 level, respectively.

5.4.4.3 INEDs' Human Capital and Social Capital Index

This study also constructed INEDs' HC and SC index using three measures of INEDs' HC and SC (i.e. INEDs functional knowledge in accounting and finance, firm-specific knowledge and external networking) to investigate the overall moderating effect of INEDs' HC and SC on RPTs-firm performance relationship. This is consistent with the argument by board capital scholars that board HC and SC have many facets (Hillman & Dalziel, 2003).

INEDs' HC and SC index is calculated based on the sum of three dummy variables, where each dummy represents INEDs' functional knowledge, INEDs' firm-specific knowledge and INEDs' external networking. Each dummy equals one if the INEDs' HC and SC measure is greater than the sample median, and zero otherwise.

The findings as shown in Table 5.10, are similar with the main analysis, suggesting that INEDs' HC and SC do not moderate the relationship between RPTs and firm performance. This indicates that the results reported earlier are robust.

Table 5.10

Regression Results for the Moderating Effect of INEDs' HC and SC Index on RPTs - Firm Performance Relationship

Variable	Model 1		Model 2	
	Total RPTs		Types of Related Parties	
	Std. Coeff	t-Stat	Std. Coeff	t-Stat
Constant	-0.183	-2.05**	-0.180	-2.02**
RPTs	0.018	0.28		
RPTRE			0.074	0.67
RPTRP			-0.017	-0.22
INEDHSCINDEX	-0.023	-1.20	-0.024	-1.23
BIG4	-0.009	-0.73	-0.009	-0.72
BSIZE	0.001	0.29	0.001	0.30
FSIZE	0.014	2.88***	0.013	2.80***
LEV	-0.120	-4.50***	-0.120	-4.47***
CSOWN	0.071	2.43**	0.074	2.51**
CSTYPE	-0.007	-0.52	-0.006	-0.47
MOWN	0.018	0.44	0.016	0.40
RPTs*INEDHSCINDEX	0.105	0.94		
RPTRE*INEDHSCINDEX			0.092	0.48
RPTRP*INEDHSCINDEX			0.104	0.78
Industry	Included		Included	
Adjusted R-squared	0.106		0.105	
F-statistic	3.212***		2.944***	
Observations	300		300	

Notes: ROA = net profit divided by total assets; RPTs = the sum of the monetary values of RPTs scaled by the total assets; RPTRE = the sum of the monetary values of RPTRE scaled by the total assets; RPTRP = the sum of the monetary values of RPTRP scaled by the total assets; INEDHSCINDEX = a dummy variable equals one if the INEDs' HC and SC index is greater than the sample median, and zero otherwise; BIG4 is a dummy variable coded 1 if the firm is audited by Big 4, and 0 otherwise; BSIZE = total number of directors on the board; FSIZE is natural log of total assets of the firm; LEV = total debt divided by total assets; CSOWN is the percentage of shares owned by controlling shareholder; CSTYPE is a dummy variable coded 1 if the controlling shareholder is individual or group of family and 0 otherwise; MOWN is the percentage of shares owned by management. Industry effects are included but not reported for brevity

***, **, * indicate significance at the 0.01, 0.05 and 0.10 level, respectively.

5.4.4.4 Curvilinear Moderation Analysis

Some scholars have argued that there may be a curvilinear relationship between INEDs' HC and SC and their monitoring and advising roles (Brown et al., 2017; Kor & Sundaramurthy, 2009). Specifically, they suggest that as the level of INEDs' HC and SC increases, INEDs are seen as more effective monitors and advisors, but when the level of their HC and SC is too high, their effectiveness decreases (i.e. the negative effects of INEDs' HC and SC start to outweigh the positive effects).

Therefore, to ensure the robustness of the main findings, this study also examined the potential curvilinear moderating effects of INEDs' HC and SC by incorporating INEDs' HC and SC squared term in the regression model. As shown in Table 5.11a and Table 5.11b, the squared terms ($RPTs_INEDFUNK^2$, $RPTs_INEDSPEK^2$, $RPTs_INEDNET^2$, $RPTRE_INEDFUNK^2$, $RPTRE_INEDSPEK^2$, $RPTRE_INEDNET^2$, $RPTRP_INEDFUNK^2$, $RPTRP_INEDSPEK^2$ and $RPTRP_INEDNET^2$) were not significant, suggesting INEDs' HC and SC as not having a nonlinear moderating effect on the relationship between RPTs and firm performance.

Table 5.11a
Regression Results for the Curvilinear Moderating Effect of INEDs' HC and SC on RPTs - Firm Performance Relationship

Variable	Model 1		Model 2		Model 3	
	Functional Knowledge		Firm-specific Knowledge		External Networking	
	Std. Coeff	t-Stat	Std. Coeff	t-Stat	Std. Coeff	t-Stat
Constant	-0.194	-2.00**	-0.208	-2.16**	-0.212	-2.24**
RPTs	0.092	2.39**	0.051	1.29	0.085	2.03**
INEDFUNK	-0.036	-0.51				
INEDSPEK			0.000	0.01		
INEDNET					0.002	0.12
INEDFUNK ²	0.034	0.50				
INEDSPEK ²			0.000	-0.20		
INEDNET ²					-0.001	-0.30
INEDPROP	0.023	0.44	0.021	0.41	0.022	0.44
BIG4	-0.011	-0.91	-0.012	-0.95	-0.009	-0.77
BSIZE	0.001	0.27	0.001	0.28	0.001	0.30
FSIZE	0.013	2.71***	0.014	2.87***	0.014	2.79***
LEV	-0.121	-4.52***	-0.121	-4.49***	-0.121	-4.43***
CSOWN	0.074	2.49**	0.073	2.47**	0.073	2.43**
CSTYPE	-0.007	-0.50	-0.007	-0.57	-0.008	-0.58
MOWN	0.011	0.28	0.019	0.47	0.017	0.40
RPTs*INEDFUNK	-0.100	-0.62				
RPTs*INEDSPEK			0.002	0.22		
RPTs*INEDNET					-0.002	-0.04
RPTs*INEDFUNK ²	-0.386	-0.89				
RPTs*INEDSPEK ²			0.001	0.90		
RPTs*INEDNET ²					-0.016	-0.52
Industry	Included		Included		Included	
Adjusted R-squared	0.100		0.100		0.091	
F-statistic	2.715***		2.653***		2.570***	
Observations	300		300		300	

Notes: ROA = net profit divided by total assets; RPTs = the sum of the monetary values of RPTs scaled by the total assets; INEDFUNK = total number of INEDs with financial expertise divided by total number of INEDs; INEDFUNK² = the squared percentage of INEDFUNK; INEDSPEK = INEDs' tenure divided by total number of INEDs; INEDSPEK² = the squared percentage of INEDSPEK; INEDNET = INEDs' directorships divided by total number of INEDs; INEDNET² = the squared percentage of INEDNET; BIG4 is a dummy variable coded 1 if the firm is audited by Big 4, and 0 otherwise; BSIZE = total number of directors on the board; FSIZE is natural log of total assets of the firm; LEV = total debt divided by total assets; CSOWN is the percentage of shares owned by controlling shareholder; CSTYPE is a dummy variable coded 1 if the controlling shareholder is individual or group of family and 0 otherwise; MOWN is the percentage of shares owned by management. Industry effects are included but not reported for brevity

***, **, * indicate significance at the 0.01, 0.05 and 0.10 level, respectively.

Table 5.11b
Regression Results for the Curvilinear Moderating Effects of INEDs' HC and SC on RPTs (Based on Types of Related Parties) - Firm Performance Relationship

Variable	Model 1		Model 2		Model 3	
	Functional Knowledge		Firm-specific Knowledge		External Networking	
	Std. Coeff	t-Stat	Std. Coeff	t-Stat	Std. Coeff	t-Stat
Constant	-0.196	-2.01**	-0.186	-1.92*	-0.210	-2.21**
RPTRE	0.168	2.74***	0.073	1.24	0.142	2.10**
RPTRP	0.042	0.81	0.031	0.57	0.042	0.66
INEDFUNK	-0.036	-0.51				
INEDSPEK			-0.002	-0.40		
INEDNET					0.002	0.09
INEDFUNK ²	0.035	0.52				
INEDSPEK ²			0.000	0.22		
INEDNET ²					-0.001	-0.25
INEDPROP	0.030	0.57	0.009	0.17	0.023	0.44
BIG4	-0.011	-0.94	-0.011	-0.90	-0.009	-0.77
BFSIZE	0.001	0.27	0.000	0.07	0.001	0.31
FFSIZE	0.013	2.61***	0.014	2.79***	0.013	2.70***
LEV	-0.120	-4.43***	-0.121	-4.49***	-0.119	-4.33***
CSOWN	0.080	2.65***	0.077	2.60***	0.076	2.50**
CSTYPE	-0.006	-0.48	-0.008	-0.58	-0.007	-0.53
MOWN	0.013	0.31	0.017	0.41	0.015	0.37
RPTRE*INEDFUNK	0.139	0.53				
RPTRP*INEDFUNK	-0.235	-1.17				
RPTRE*INEDSPEK			-0.021	-1.19		
RPTRP*INEDSPEK			0.012	1.02		
RPTRE*INEDNET					-0.014	-0.22
RPTRP*INEDNET					0.003	0.06
RPTRE*INEDFUNK ²	-0.917	-1.32				
RPTRP*INEDFUNK ²	-0.082	-0.15				
RPTRE*INEDSPEK ²			0.004	1.46		
RPTRP*INEDSPEK ²			0.000	-0.14		
RPTRE*INEDNET ²					-0.020	-0.39
RPTRP*INEDNET ²					-0.009	-0.17
Industry	Included		Included		Included	
Adjusted R-squared	0.100		0.100		0.090	
F-statistic	2.486***		2.514***		2.297***	
Observations	300		300		300	

Table 5.11b (continued)

Notes: ROA = net profit divided by total assets; RPTRE = the sum of the monetary values of RPTRE scaled by the total assets; RPTRP = the sum of the monetary values of RPTRP scaled by the total assets; INEDFUNK = total number of INEDs with financial expertise divided by total number of INEDs; INEDSPEK = INEDs' tenure divided by total number of INEDs; INEDNET = INEDs' directorships divided by total number of INEDs; BIG4 is a dummy variable coded 1 if the firm is audited by Big 4, and 0 otherwise; BSIZE = total number of directors on the board; FSIZE is natural log of total assets of the firm; LEV = total debt divided by total assets; CSOWN is the percentage of shares owned by controlling shareholder; CSTYPE is a dummy variable coded 1 if the controlling shareholder is individual or group of family and 0 otherwise; MOWN is the percentage of shares owned by management. Industry effects are included but not reported for brevity

***, **, * indicate significance at the 0.01, 0.05 and 0.10 level, respectively.

5.4.4.5 Alternative Measure for Firm Performance

This study used accounting-based measure (i.e. ROA) as a proxy to measure firm performance. However, some scholars have argued that ROA is subject to managerial manipulation and not affected by shareholders perspective (Cornett, McNutt, & Tehranian, 2009; Gentry & Shen, 2010). Therefore, to ensure the robustness of the main findings, market-based measure (i.e. Tobin's Q) is used as an alternate measure of firm performance. The difference between ROA and Tobin's Q is that ROA is an indicator for past and short-term financial performance whereas Tobin's Q is an indicator for future and long-term financial performance (Gentry & Shen, 2010). Both measures have been widely used in corporate governance research.

Tobin's Q is the ratio of the market value of a firm's assets to their replacement cost. Market value of assets is calculated as the market value of equity plus the book value of assets minus the book value of equity. The replacement cost is proxied by the book value of assets, which is consistent with previous studies. The equation is shown here:

$$\text{Tobin's } Q = (\text{MVE}_{it} + \text{BVA}_{it} - \text{BVE}_{it}) / \text{BVA}_{it}$$

Where, MVE_{it} is a market value of equity for firm i in year t ; BVA_{it} is total assets for firm i in year t ; and BVE_{it} is book value of equity of firm i in year t .

The results as shown in Table 5.12a and Table 5.12b are similar to the main findings except for the moderating effects of INEDs' functional knowledge in accounting and finance ($RPTs*INEDFUNK$), INEDs' firm-specific knowledge ($RPTRP*INEDSPEK$) and INEDs' external networking ($RPTs*INEDNET$ and $RPTRP*INEDNET$). Specifically, the results show that RPTs (RPTRE) have a positively significant effect on firm performance, as measured by Tobin's Q at 1% (5%) significance level. The results imply that investors perceive such transactions to be value enhancing. However, this study did not find any relationship between RPTRP and firm performance, suggesting that investors differentiate the impact of each type of RPTs on firm performance.

For the moderating effect of the proportion of INEDs, this study did not find a significant moderating effect of the proportion of INEDs on the relationship between RPTs (total RPTs and types of party) and firm performance. The results indicate that the presence of higher number of INEDs on corporate boards does not influence investors in valuing RPTs (total RPTs and types of party).

For the moderating effects of INEDs' HC and SC, Model 3 in Table 5.12a shows that INEDs' functional knowledge in accounting and finance has a negatively significant moderating effect on the relationship between RPTs and Tobin's Q at 10% significance level, such that the relationship weakens when the percentage of INEDs with financial expertise is higher. Thus, the result marginally supports the argument

by Persons (2005) that when there are more INEDs with financial expertise on the board, there is a possibility that the free-rider problem would diminish the benefits of INEDs' financial expertise.

Model 4 in Table 5.12b shows that INEDs' firm-specific knowledge has a positively significant moderating effect on the relationship between RPTRP and Tobin's Q at 10% significance level, such that the relationship strengthens when the board has INEDs with higher level of firm-specific knowledge. Thus, the result marginally supports the hypothesis that the level of INEDs' firm-specific knowledge influences investors in valuing transactions with related person.

Model 5 in Table 5.12a and Table 5.12b shows that INEDs' external networking has a positively significant moderating effect on the relationship between RPTs (RPTRP) and Tobin's Q at 5% (1%) significance level, such that relationship is strengthened when the board has INEDs with higher level of external networking. Thus, the result supports the hypothesis that the level of INEDs' external networking influences investors in valuing RPTs and RPTRP.

Table 5.12a

Regression Results for the Effect of RPTs on Firm Performance (Tobin's Q)

Variables	Control Variables and RPTs		Proportion of INEDs		Model 3 Functional Knowledge		INEDs' HC and SC Model 4 Firm-specific Knowledge		Model 5 External Networking	
	Model 1		Model 2							
	Std. Coeff	t-Stat	Std. Coeff	t-Stat	Std. Coeff	t-Stat	Std. Coeff	t-Stat	Std. Coeff	t-Stat
Constant	1.423	1.92*	1.162	1.63	1.522	1.94*	1.439	1.97*	1.466	2.06**
RPTs	0.983	2.72***	0.983	2.72***	1.023	2.73***	0.995	2.74***	0.880	2.72***
INEDPROP			0.471	1.18						
INEDFUNK					-0.121	-0.71				
INEDSPEK							-0.011	-1.04		
INEDNET									0.025	0.78
ROA	2.144	1.99**	2.132	1.99**	2.056	1.96*	2.114	1.96*	2.170	2.03**
BIG4	0.020	0.24	0.022	0.26	0.019	0.22	0.021	0.27	0.006	0.08
BSIZE	0.060	2.75***	0.073	2.87***	0.053	2.55**	0.058	2.72***	0.063	2.91***
FSIZE	-0.039	-0.95	-0.043	-1.04	-0.038	-0.93	-0.035	-0.86	-0.041	-1.05
LEV	0.489	1.94*	0.507	1.97*	0.472	1.84*	0.465	1.82*	0.475	1.90*
CSOWN	-0.060	-0.22	-0.005	-0.02	-0.038	-0.14	-0.057	-0.21	-0.094	-0.34
CSTYPE	-0.056	-0.57	-0.059	-0.60	-0.036	-0.37	-0.053	-0.54	-0.053	-0.54
MOWN	-0.419	-1.67*	-0.356	-1.45	-0.512	-1.94*	-0.407	-1.62	-0.453	-1.71*
RPTs*INEDPROP			-1.092	-0.38						
RPTs*INEDFUNK					-2.542	-1.76*				
RPTs*INEDSPEK							0.044	0.53		
RPTs*INEDNET									0.696	2.19**

Table5.12a (continued)

Variables	Control Variables and RPTs		Proportion of INEDs		INEDs' HC and SC					
	Model 1		Model 2		Model 3 Functional Knowledge		Model 4 Firm-specific Knowledge		Model 5 External Networking	
	Std. Coeff	t-Stat	Std. Coeff	t-Stat	Std. Coeff	t-Stat	Std. Coeff	t-Stat	Std. Coeff	t-Stat
Industry	Included		Included		Included		Included		Included	
Adjusted R-squared	0.177		0.176		0.189		0.175		0.196	
F-statistic	5.279***		4.757***		5.090***		4.732***		5.279***	
Observations	300		300		300		300		300	

Notes: Tobin's Q = is the ratio of the market value of a firm's assets to their book value of assets; RPTs = the sum of the monetary values of RPTs scaled by the total assets; INEDFUNK = total number of INEDs with financial expertise divided by total number of INEDs; INEDSPEK = INEDs' tenure divided by total number of INEDs; INEDNET = INEDs' directorships divided by total number of INEDs; BIG4 is a dummy variable coded 1 if the firm is audited by Big 4, and 0 otherwise; BSIZE = total number of directors on the board; FSIZE is natural log of total assets of the firm; LEV = total debt divided by total assets; CSOWN is the percentage of shares owned by controlling shareholder; CSTYPE is a dummy variable coded 1 if the controlling shareholder is individual or group of family and 0 otherwise; MOWN is the percentage of shares owned by management. Industry effects are included but not reported for brevity

***, **, * indicate significance at the 0.01, 0.05 and 0.10 level, respectively.

Table 5.12b

Regression Results for the Effect of RPTs (Types of Related Parties) on Firm Performance (Tobin's Q)

Variables	Control Variables and Types of Related Parties		Proportion of INEDs		INEDs' Human and Social Capita					
	Model 1		Model 2		Model 3 Functional Knowledge		Model 4 Firm-specific Knowledge		Model 5 External Networking	
	Std. Coeff	t-Stat	Std. Coeff	t-Stat	Std. Coeff	t-Stat	Std. Coeff	t-Stat	Std. Coeff	t-Stat
Constant	1.450	2.00**	1.183	1.70*	1.540	2.01**	1.536	2.15**	1.442	2.08**
RPTRE	1.683	2.45**	1.757	2.42**	1.727	2.49**	1.680	2.60***	1.612	2.28**
RPTRP	0.487	1.03	0.447	0.93	0.483	0.95	0.511	1.02	0.437	1.08
INEDPROP			0.422	1.16						
INEDFUNK					-0.129	-0.78				
INEDSPEK							-0.017	-1.38		
INEDNET									0.025	0.78
ROA	2.062	1.90*	2.023	1.90*	2.005	1.90*	1.948	1.84*	2.057	1.97*
BIG4	0.020	0.24	0.023	0.28	0.021	0.26	0.019	0.25	0.001	0.02
BSIZE	0.060	2.82***	0.071	2.82***	0.053	2.62***	0.056	2.65***	0.060	2.80***
FSIZE	-0.043	-1.08	-0.045	-1.13	-0.041	-1.04	-0.039	-0.99	-0.042	-1.12
LEV	0.489	1.94*	0.518	1.98**	0.501	1.94*	0.429	1.65	0.506	2.01**
CSOWN	-0.021	-0.08	0.050	0.19	0.013	0.05	0.008	0.03	-0.065	-0.25
CSTYPE	-0.048	-0.50	-0.048	-0.49	-0.038	-0.38	-0.056	-0.60	-0.068	-0.68
MOWN	-0.436	-1.76*	-0.389	-1.58	-0.522	-1.96*	-0.420	-1.72*	-0.452	-1.76*
RPTRE*INEDPROP			1.618	0.27						
RPTRP*INEDPROP			-3.628	-1.30						
RPTRE*INEDFUNK					-4.613	-1.64				
RPTRP*INEDFUNK					-1.086	-0.60				

Table 5.12b (continued)

Variables	Control Variables and Types of Related Parties		Proportion of INEDs				INEDs' Human and Social Capita			
	Model 1		Model 2		Model 3 Functional Knowledge		Model 4 Firm-specific Knowledge		Model 5 External Networking	
	Std. Coeff	t-Stat	Std. Coeff	t-Stat	Std. Coeff	t-Stat	Std. Coeff	t-Stat	Std. Coeff	t-Stat
RPTRE*INEDSPEK							-0.213	-0.95		
RPTRP*INEDSPEK							0.168	1.86*		
RPTRE*INEDNET									-0.168	-0.32
RPTRP*INEDNET									1.299	2.65***
Industry	Included		Included		Included		Included		Included	
Adjusted R-squared	0.190		0.190		0.207		0.203		0.225	
F-statistic	5.381***		4.686***		5.105***		5.017***		5.578***	
Observations	300		300		300		300		300	

Notes: Tobin's Q = is the ratio of the market value of a firm's assets to their book value of assets; RPTRE = the sum of the monetary values of RPTRE scaled by the total assets; RPTRP = the sum of the monetary values of RPTRP scaled by the total assets; INEDFUNK = total number of INEDs with financial expertise divided by total number of INEDs; INEDSPEK = INEDs' tenure divided by total number of INEDs; INEDNET = INEDs' directorships divided by total number of INEDs; BIG4 is a dummy variable coded 1 if the firm is audited by Big 4, and 0 otherwise; BSIZE = total number of directors on the board; FSIZE is natural log of total assets of the firm; LEV = total debt divided by total assets; CSOWN is the percentage of shares owned by controlling shareholder; CSTYPE is a dummy variable coded 1 if the controlling shareholder is individual or group of family and 0 otherwise; MOWN is the percentage of shares owned by management. Industry effects are included but not reported for brevity

***, **, * indicate significance at the 0.01, 0.05 and 0.10 level, respectively.

5.4.4.6 Related Party Transactions – Based on Types of Transactions

Additional regression analyses classifying RPTs into operating RPTs and non-operating RPTs were conducted to examine whether the observed effect (RPTs on firm performance) varies by the types of RPTs. Operating RPTs (RPTOP) include sale of goods and services, rent income, other operating income, payment for raw material and finished goods, marketing expense, processing expense, rent expense, royalty expense, reimbursement of expenses to/by related parties and other operating expenses. Non-operating RPTs (RPTNONOP) consist of loans and guarantees given during the year, loans and guarantees taken during the year, purchase/sale of fixed assets, purchase/sale of investments, capital issued during the year, interest payment, interest income, dividend payment, dividend income. The classifications are consistent with Habib et al. (2015), Lee, Kang, Lee, and Park (2014) and Li (2018). RPTOP (RPTNONOP) was measured as the sum of the RPTOP (RPTNONOP) divided by the total assets.

Table 5.13a and Table 5.13b shows that different types of RPTs affect firm performance differently. Specifically, as shown in Table 5.13a and Table 5.13b, the coefficient of the RPTNONOP were positive (0.136 and 0.1971 respectively) and significant at level $p < 0.05$. The positive relationship implies that non-operating RPTs increase firm performance. The finding gives support to the value-enhancing view of non-operating RPTs. However, this study did not find any relationship between operating RPTs (RPTOP) and firm performance. The results contradict findings of Kohlbeck and Mayhew (2010) Habib et al. (2015) and Lee et al. (2014). The positive relationship between non-operating RPTs and firm performance may be due to the many reforms undertaken by the Malaysian government to curb abusive RPTs,

particularly non-routine transactions such as loans and sales/purchases of non-current assets.

Table 5.13a
Regression Results for the Effect of RPTs (based on types of transactions) on Firm Performance (ROA)

Variable	ROA	
	Std. Coeff.	t-Stat
Constant	-0.199	-2.236**
RPTOP	0.037	0.974
RPTNONOP	0.136	2.449**
BIG4	-0.010	-0.859
BSIZE	0.000	0.126
FSIZE	0.014	2.862***
LEV	-0.113	-4.154***
CSOWN	0.073	2.489**
CSTYPE	-0.008	-0.624
MOWN	0.010	0.252
Industry	Included	
Adjusted R-squared	0.108	
F-statistic	3.412***	
Observations	300	

Notes: ROA = net profit divided by total assets; RPTROP = the sum of the monetary values of RPTOP scaled by the total assets; RPTNONOP = the sum of the monetary values of RPTNONOP scaled by the total assets; BIG4 is a dummy variable coded 1 if the firm is audited by Big 4, and 0 otherwise; BSIZE = total number of directors on the board; FSIZE is natural log of total assets of the firm; LEV = total debt divided by total assets; CSOWN is the percentage of shares owned by controlling shareholder; CSTYPE is a dummy variable coded 1 if the controlling shareholder is individual or group of family and 0 otherwise; MOWN is the percentage of shares owned by management. Industry effects are included but not reported for brevity.

***, **, * indicate significance at the 0.01, 0.05 and 0.10 level, respectively.

Table 5. 13b

Regression Results for the Effect of RPTs (based on types of transactions) on Firm Performance (Tobin's Q)

Variable	Tobin's Q	
	Std. Coeff.	t-Stat
Constant	0.907	1.226
RPTOP	0.734	1.283
RPTNONOP	1.971	2.465**
BIG4	0.001	0.011
BSIZE	0.059	2.752***
FSIZE	-0.007	-0.180
LEV	0.329	1.349
CSOWN	0.104	0.403
CSTYPE	-0.080	-0.787
MOWN	-0.441	-1.487
Industry	Included	
Adjusted R-squared	0.129	
F-statistic	3.951***	
Observations	300	

Notes: Tobin's Q = is the ratio of the market value of a firm's assets to their book value of assets; RPTROP = the sum of the monetary values of RPTOP scaled by the total assets; RPTNONOP = the sum of the monetary values of RPTNONOP scaled by the total assets; BIG4 is a dummy variable coded 1 if the firm is audited by Big 4, and 0 otherwise; BSIZE = total number of directors on the board; FSIZE is natural log of total assets of the firm; LEV = total debt divided by total assets; CSOWN is the percentage of shares owned by controlling shareholder; CSTYPE is a dummy variable coded 1 if the controlling shareholder is individual or group of family and 0 otherwise; MOWN is the percentage of shares owned by management. Industry effects are included but not reported for brevity.

***, **, * indicate significance at the 0.01, 0.05 and 0.10 level, respectively.

5.5 Summary and Conclusion

This chapter discusses the empirical results regarding the effect of RPTs on firm performance and whether the effect is moderated by the proportion of INEDs and their HC and SC. Firm performance was measured by ROA and RPTs were measured based on total RPTs and types of related parties. Transactions with related parties were classified into two main groups: transactions with related entities, which includes subsidiaries, associates and joint ventures (RPTRE); and transactions with related persons which include directors, major shareholders, persons connected with directors or major shareholders or director related entities (RPTRP).

Two conclusions can be drawn from the results of this study. First, this study provides evidence that, on average, RPTs are not harmful to minority shareholders. Specifically, the results indicate that RPTs in general have a positive effect on firm performance. Based on types of related parties, the results reveal that transactions with different types of related parties affect firm performance differently and transactions with subsidiaries and affiliated firms have a greater effect in enhancing firm performance. The positive effect implies that a firm with higher RPTs has a higher firm performance, and thus supports the value-enhancing view (i.e. efficient transaction hypothesis) of RPTs. The results are robust either using ROA or Tobin's Q as a measure of firm performance, and support Neikhili and Cheriff (2011) and Ryngaert and Thomas (2012) regarding the effect of different types of RPTs on firm performance.

Second, contrary to expectation, this study documented that the proportion of INEDs and their HC and SC do not moderate the RPTs-firm performance relationship, suggesting that the attributes do not necessarily improve INEDs' ability to perform their monitoring and advice-giving functions relating to RPTs. The insignificant findings contradict with the arguments from the agency, resource dependence, human capital and social capital theories.

Results from the additional analyses stayed in line with the main findings except for the moderating effects of INEDs' HC and SC. The results provide marginal evidence that investors take into consideration INEDs' HC and SC in valuing certain types of RPTs.

CHAPTER SIX

CONCLUSION AND RECOMMENDATION

6.1 Introduction

This final chapter reviews the research findings and discusses the key implications and limitations of the research, with some suggestions for future research. Section 6.2 begins with an overview of the study. Subsequently, Section 6.3 summarises the major findings. Section 6.4 explains the potential implications of the findings, while Section 6.5 highlights the research limitations and provides suggestions for future research. Finally, Section 6.6 draws the overall conclusions of this study.

6.2 Overview of the Study

After the 1997/1998 Asian financial crisis and the occurrences of many corporate scandals, RPTs and the role of INEDs in corporate governance have received greater attention from academics and policy makers. RPTs have been proven to act as a major instrument used by controlling shareholders to extract private benefits, particularly in companies with weak governance and monitoring mechanisms. Consequently, the concept of board independence has been strengthened and it becomes one of the centrepieces of corporate governance reforms. INEDs, who are independent from the influence of insiders, are expected to limit the potential opportunism of the insiders in a principal-agent relationship. There is an expectation that INEDs play a critical role in monitoring RPTs, such as designing approval process for RPTs, conducting investigations, and obtaining advice from independent experts (OECD, 2009).

Therefore, this study extended the research on RPTs and INEDs by examining the effect of RPTs on firm performance and whether this effect is moderated by the

proportion of INEDs and their HC and SC. Drawing from prior research and corporate governance reforms, this study focused on three constructs to capture INEDs' HC and SC, namely INEDs' functional knowledge in accounting and finance, INEDs' firm-specific knowledge, and INEDs' external networking. Consistent with the resource dependence, human capital, and social capital theories, this study argued that while INEDs have the incentives to monitor the insiders, those with higher level of HC and SC in terms of knowledge, experience, and networking, may perform their roles more effectively.

Accordingly, a cross-sectional study of listed non-financial companies in Malaysia was conducted. The year 2013 was chosen as it was the most recent year available at the time of data collection. Malaysia provides an ideal setting to study the issues above due to its unique institutional features such as concentrated ownership structure, inefficient external market, poor corporate governance, and lack of shareholder protection, mainly for the minority shareholders (Claessens et al., 2000). Notably, such features may result in the widespread use of RPTs.

6.3 Summary of Major Findings

6.3.1 Research Question 1: RPTs and Firm Performance

The first objective of this study was to examine the effect of RPTs (based on total RPTs and types of related parties) on firm performance among Malaysian firms. Consistent with prior research and the conflict of interest view, this study argued that in general, RPTs are likely to have a negative effect on firm performance. Contrary to expectations, the results indicated that RPTs do not harm, and perhaps even benefit, the shareholders. The results also documented that transactions with different types of

related parties affect firm performance differently and transactions with subsidiaries and affiliated firms have a greater effect in enhancing firm performance. The results were robust either using ROA or Tobin's q as a measure of firm performance. Table 6.1 provides a summary of the hypotheses testing for the effect of RPTs on firm performance.

Based on discussion provided in Chapter 5 (Section 5.4.1), the positive relationship between RPTs and firm performance may be attributed to the many reforms undertaken by the Malaysian government to reduce the prevalence of abusive RPTs, including strengthening laws, regulations, and guidelines relating to RPTs. This seems to be confirmed by a survey conducted by the World Bank in 2013, which demonstrated that Malaysia is among the top five countries with the highest investor protections index against abusive RPTs. With strong legal protection of investors, RPTs in Malaysia are more likely to be conducted for efficiency reasons, and the outcomes were translated into positive relationship between RPTs and firm performance. The findings may signal some worthwhile reforms concerning RPTs in Malaysia.

In addition, the establishment of Minority Shareholder Watchdog Group (MSWG) in 2000 may contribute in changing the shareholder activism culture in Malaysia that previously labelled as conservative and collectivist societies (Rachagan, 2007; Satkunasingam & Shanmugam, 2006). The MSWG is an independent, non-profit organization limited by guarantee, with the objective to protect the interests of minority shareholders through shareholder activism and to promote good governance and practices amongst PLCs. Findings from this study may provide some evidence on

the success of the MSWG's efforts to create awareness of the rights and protection of shareholders, and the board's responsibilities towards them.

Furthermore, under inefficient external market, RPTs can be considered as a substitute to mitigate external market failure and therefore, such transactions are perceived to be inevitable, useful, and recurring in ongoing operations in emerging countries.

Table 6.1
Summary of Hypotheses Testing for Direct Effect

	Hypotheses	Main Findings ROA	Additional Tests Tobin's Q
H1	Total RPTs: There is a negative relationship between RPTs and firm performance	Not supported	Not supported
H1a	RPTs with related entities: There is a positive relationship between RPTs with related entities and firm performance	Supported	Supported
H1b	RPTs with related persons: There is a negative relationship between RPTs with related persons and firm performance	Not supported	Not supported

6.3.2 Research Question 2: The Moderating Effect of the Proportion of INEDs

The second objective of this study was to examine the moderating effect of the proportion of INEDs on the relationship between RPTs (total RPTs and types of related parties) and firm performance. Drawing from the agency theory, this study argued that the effect of RPTs on firm performance is moderated by the presence of higher number of INEDs on the corporate board. Contrary to expectations, the proportion of INEDs does not interact with RPTs to affect firm performance, suggesting that the mere presence of INEDs does not mean that they can serve an effective governance role,

particularly in transactions involving related parties. The results remained the same for the types of related parties. Furthermore, the results were robust either using ROA or Tobin's q as a measure of firm performance. Table 6.2 provides a summary of the hypotheses testing for the moderating effect of the proportion of INEDs on RPTs-firm performance relationship.

The insignificant results raised question on whether INEDs add value to the firm. As discussed in Chapter 5 (Section 5.4.2), there are two possible explanations for the insignificant results. First, the results for the direct relationship between RPTs and firm performance suggested that RPTs in Malaysia are conducted for efficiency reasons such as to reduce transactions costs and to optimise internal resource allocation. Since RPTs are efficient transactions, it is argued that there would be no need to increase the monitoring level and thus, there would be no interaction effect between RPTs and the proportion of INEDs (Gordon et al., 2004).

Second, since RPTs are often not carried out on an arm's length basis and had been proven to be a factor in numerous accounting scandals, it is argued that even if RPTs are efficient transactions, INEDs have a vital role to play in monitoring RPTs to avoid the appearance of conflict of interest. The insignificant results may be attributed to the fact that in Malaysia, INEDs may only play a symbolic role rather than having more influence in monitoring and advising the decision making of insiders to enter into RPTs. There is a possibility that firms appoint INEDs to just meet the legal definition of independence but those INEDs are close to the management and act primarily in the interest of the insiders. Moreover, greater representation of INEDs on the board is argued to increase their monitoring incentives and thus, reduce the CEOs' willingness

to share information. Therefore, the cost for INEDs to become informed may diminish their monitoring advantages.

Table 6.2

Summary of Hypotheses Testing for the Moderating Effect of the Proportion of INEDs on RPTs-Firm Performance Relationship

	Hypotheses	Main Findings ROA	Additional Tests Tobin's Q
H2	Total RPTs: The proportion of INEDs weakens the negative relationship between RPTs and firm performance	Not supported	Not supported
H2a	RPTs with related entities: The proportion of INEDs strengthens the positive relationship between RPTs with related entities and firm performance	Not Supported	Not supported
H2b	RPTs with related persons: The proportion of INEDs weakens the negative relationship between RPTs with related persons and firm performance	Not supported	Not supported

6.3.3 Research Question 3 and 4: The Moderating Effects of INEDs' Human Capital and Social Capital

The third and fourth objectives of this study were to examine the moderating effects of INEDs' HC and SC on the relationship between RPTs (total RPTs and types of related parties) and firm performance. INEDs' HC was measured by INEDs' functional knowledge in accounting and finance and INEDs' firm-specific knowledge, while INEDs' SC was proxied by INEDs' external networking. Drawing from the resource dependence, human capital, and social capital theories, this study argued that the proportion of INEDs with higher level of financial knowledge, firm-specific knowledge, and external networking moderates the effect of RPTs on firm performance.

Contrary to expectations, all constructs for INEDs' HC and SC in the ROA model did not interact with RPTs to affect firm performance, suggesting that INEDs' functional knowledge in accounting and finance, firm-specific knowledge, and external networking do not shape the ability of INEDs to perform their monitoring and advice-giving roles, particularly in transactions involving related parties. In Tobin q's model, only INEDs' external networking was found to moderate the relationship between RPTs (total RPTs and transactions with related persons) and firm performance, suggesting that the market participants perceived that the level of INEDs' external networking is an important determinant in valuing RPTs. Table 6.3 provides a summary of the hypotheses testing for the moderating effects of INEDs' HC and SC on RPTs-firm performance relationship.

Overall, the evidence on the role of INEDs in monitoring and advising RPTs are generally weak, even though they have higher level of HC and SC. Therefore, the resource dependence, human capital, and social capital theories that stress on the importance of INEDs' HC and SC are not supported. The insignificant findings may raise questions of whether INEDs in Malaysia are just fulfilling the MCCG and BMLR requirements; or perhaps there may be due to the potential trade-off between costs and benefits of INEDs' functional knowledge in accounting and finance, INEDs' firm-specific knowledge, and INEDs' external networking, which in turn would compromise INEDs' ability to effectively protect the interests of the shareholders.

In Malaysia, the weak involvement of INEDs in RPT's activities may be caused by several barriers that may hinder them from being effective corporate monitors and advisors. As explained in details in Chapter 5 (Section 5.4.3), INEDs may face: (i)

excessive information processing demands that would limit their cognitive ability as they have to serve in a number of watchdog committees; (ii) information asymmetries in which management has the incentives to conceal information from INEDs if RPTs are designed to extract wealth from the firm, or this may be due to the cultural effect that the management of Chinese companies tends to become secretive in sharing information with outsiders; (iii) substantial social influence and pressure from the CEOs and the controlling shareholders which may impair the independence of INEDs and hence, undermine the ability of INEDs to carry their duties objectively and effectively; (iv) time constraints in which they are employed as part-time board members and therefore, it may be impossible for even INEDs with higher level of HC and SC to provide sound recommendations to the management and to effectively monitor them.



Table 6.3

Summary of Hypotheses Testing for the Moderating Effects of INEDs' Human Capital and Social Capital on RPTs-Firm Performance Relationship

	INEDS' HC and SC	Hypotheses	Main Findings	Additional Tests
			ROA	Tobin's Q
H3	Functional Knowledge in Accounting and Finance	Total RPTs:		
		INEDs' functional knowledge in accounting and finance weakens the negative relationship between RPTs and firm performance relationship	Not supported	Not supported
H3a		RPTs with related entities:		
		INEDs' functional knowledge in accounting and finance strengthens the positive relationship between RPTs with related entities and firm performance	Not supported	Not supported
H3b		RPTs with related persons:		
		INEDs' functional knowledge in accounting and finance weakens the negative relationship between RPTs with related persons and firm performance	Not supported	Not supported
H4	Firm-specific Knowledge	Total RPTs:		
		INEDs' firm-specific knowledge weakens the negative relationship between RPTs and firm performance	Not supported	Not supported
H4a		RPTs with related entities:		
		INEDs' firm-specific knowledge strengthens the positive relationship between RPTs with related entities and firm performance	Not supported	Not supported
H4b	RPTs with related persons:			
	INEDs' firm-specific knowledge weakens the negative relationship between RPTs with related persons and firm performance	Not supported	Marginally supported	

Table 6.3 (continued)

	INEDS' HC and SC	Hypotheses	Main Findings	Additional Tests
			ROA	Tobin's Q
H5		Total RPTs:		
		INEDs' external networking weakens the negative relationship between RPTs and firm performance	Not supported	Supported
H5a	External Networking	RPTs with related entities:		
		INEDs' external networking strengthens the positive relationship between RPTs with related entities and firm performance	Not supported	Not supported
H5b		RPTs with related persons:		
		INEDs' external networking weakens the negative relationship between RPTs with related persons and firm performance	Not supported	Supported

6.4 Implications of the Study

The findings of this study have several implications for investors, companies, theories, regulators, and policy makers, which are discussed in depth in the following subsections.

6.4.1 Implications for Investors and Companies

The findings provide additional information that might be useful in decision making related to investment. In particular, the positive relationship between RPTs and firm performance that was found in this study might indicate to the existing and potential investors that RPTs do not necessarily affect a company negatively, provided that the transactions are managed in a transparent and legal manner. Due to the inefficient external market faced by the emerging countries including Malaysia, there may be a

number of RPTs that are unavoidable and can be used for sound business reasons. For example, transactions involving subsidiaries, associates, and joint ventures, which are subject to common control can help lower the cost of transactions, mitigate holdup problems in the contracting process, and increase contract efficiency as opposed to transactions with non-related parties. More importantly, the results may send a signal to investors about the seriousness of Malaysian government to offer greater investor's rights and protection.

While RPTs are considered as efficient transactions, the special relationship inherent between the involved parties may create potential risks of conflict and therefore, these transactions require special company's attention. It is vital for a company to ensure that sufficient related party policy, controls, and procedures are established and enforced. All relevant RPTs as well as the decision-making process for approving RPTs should be transparent and consistently disclosed because such information is argued to influence the investors' decision making and confidence towards a company's financial performance and position.

6.4.2 Implications for Theories

This study provides evidence on the usefulness of the efficient transactions hypothesis in explaining the effect of RPTs on firm performance, particularly in the institutional context where capital, labour, and product markets are not efficient. Various forms of RPTs which include intra-group dealings may be created to supplement inefficient external market and therefore, such transactions are argued to have beneficial effects for the company and shareholders. The efficient transactions hypothesis postulates that

RPTs can retain skilled and knowledgeable executive, as well as can provide more efficient resource allocation, economies of scale, and better access to finance.

Nevertheless, the possibility of wealth transfers via certain types of RPT is undeniable as this study discovered that only transactions involving subsidiaries, associates, and joint ventures have a positive effect on firm performance. Therefore, the conflict of interest hypothesis, which is consistent with the agency theory, still plays a role in shaping the benefits and costs of RPTs.

With regards to the role of INEDs, this study provides either no support or only weak support on the moderating effects of the proportion of INEDs and their HC and SC on the RPTs-firm performance relationship. The findings imply that while the agency, resource dependence, human capital, and social capital theories seem useful in explaining the monitoring and advising roles of INEDs as discussed in Chapter 3.2, their explaining power may be limited due to some inherent limitations attached to the theories. For example, the resource dependence theory disregards the importance of cultural factors while the human capital theory is primarily based on the concept of rationality and thus, disregards the concept of bounded rationality such as cognitive limitations and imperfect information. Such limitations as explained in Chapter 5.4.3 may diminish the benefits of INEDs' HC and SC. Therefore, future studies should look into the cultural and bounded rationality factors to provide more insights on the extent to which INEDs perform their governing and advising functions.

6.4.3 Implications for Regulators and Policy Makers

The Asian financial crises of 1997/1998 has highlighted instances of corporate abuse through RPTs. The incidents were partially attributable to weaknesses in the legal framework, which have enabled controlling shareholders to engage in abusive RPTs. Accordingly, numerous efforts have been taken by the Malaysian government such as through stringent RPTs disclosure under the MFRS and the BMLR, the establishment of the MSWG, and the incorporation of the provisions to regulate substantial property transactions with related parties into the Companies Act. These reforms aimed at strengthening the rules protecting shareholders against corporate wrongdoings and to boosting investor confidence.

This study, which documented that RPTs are conducted for efficiency reasons, lends support to regulatory on the significance and effectiveness of the recent reforms. In other words, the enhanced rules and regulatory framework relating to RPTs are viewed as having some success in limiting the opportunistic behaviour of the corporate insiders. This seems to be supported by the investor protection ranking produced by the World Bank in 2013. The ranking showed that Malaysia retains its 4th position for investor protections index against abusive RPTs. Moreover, Kohlbeck and Mayhew (2010) argued that stringent rules and regulations relating to RPTs disclosures can help investor either to discipline opportunistic behaviour of the corporate insiders or to take precautions against it. Findings from this study may indicate that transparent and consistent disclosure or RPTs in Malaysia can help in alleviating the adverse effects of RPTs.

With regards to INEDs in Malaysia, great reliance has been placed on them to represent the interest of the minority shareholders. As a guardian of the minority shareholders, there is an expectation for the INEDs to scrutinise the proposed RPTs undertaken by a firm to ensure that the transactions are fair, reasonable, and are in the best interest of all shareholders. However, the findings from this study provide limited evidence that INEDs influence in decision making relating to RPTs. The results implied that the MCCG recommendations and the BMLR requirements for the PLCs to have majority of INEDs on the board and INEDs should have necessary skills and expertise may not work in Malaysia. The insignificant results raise questions of whether INEDs in Malaysia are truly independent or just fulfilling the MCCG and BMLR requirements.

Empirical evidence from this study expresses concern on the current recommendation by the MCCG 2017 to increase the representation of INEDs on the board. The findings suggest that instead of focusing on increasing the board's independence, Malaysian regulators and policy makers should focus on the substance of how INEDs should perform their roles, what information are given to them, and what barriers that they face in their roles.

The concept of INEDs was first originated in dispersed ownership structures as a means to strengthen the board's monitoring role. It was then transplanted to other jurisdictions, including Malaysia. The concept of INEDs in emerging countries is argued to resemble those of developed countries in form, but not in substance. Hence, how the concept fits into the local legal systems has drawn widespread attention from the scholars. Since Malaysia's institutional features are different from those Western countries, it is essential for Malaysian regulators to consider the unique ownership

structure, as well as the cultural, social, and political contexts of Malaysian listed companies.

Whether INEDs can play effective governance and advisory roles depends not only on the proportion of INEDs, their HC, and SC, but also to a large degree on the internal and external corporate environments. Thus, it is vital to create a more conducive environment for INEDs to fulfil their roles. For example, there should be a mechanism that can minimise the information barrier faced by INEDs so that adequate and comprehensive information on a company's matters including RPTs can be provided to INEDs in a timely manner.

In terms of culture, most companies in Malaysia have been influenced by the traditional Chinese culture (i.e. Guanxi). Accordingly, this might indicate that the social ties between corporate insiders and INEDs do matter in corporate governance reforms as the ties are argued to impair the independence of INEDs. Hence, Malaysian regulators and policy makers should provide some kind of legal control over social ties to ensure that INEDs can provide effective checks and balances on the board.

6.5 Limitations and Future Studies

This study suffers from a few limitations that future research may address. First is the scope of the study; this study adopted Malaysian data to examine the effect of RPTs and the moderating role of the proportion of INEDs and their HC and SC on firm performance. Furthermore, this study did not cover financial institutions such as bank, insurance companies, and unit trusts. While this approach can gauge a more accurate and comprehensive data, it may limit the generalisation of the outcomes of this study to other institutional settings due to the differences in ownership structure, regulatory

environment, and corporate governance practices. Future studies should extend this research to cover the financial industries and other countries to enhance the generalisability of the findings beyond the country-specific or industry-specific context.

The second limitation is regarding the data collection process. Data related to RPTs and INEDs were collected by the researcher based on the information disclosed in the companies' annual reports. Nevertheless, the use of annual reports may raise some concerns. There is a possibility that firms engaging in RPTs do not disclose the information publicly as they may not be subject to the disclosure requirements by BMLR and MASB, or such information may be concealed by the management for their own interest. Therefore, the data on RPTs in this study were limited to the information disclosed in the annual reports.

Other disclosure channels such as circulars to the shareholders and minutes of shareholders' or directors' meetings should be considered in future studies. By extending the scope of data collection, future studies may capture more detailed information relating to RPTs. For INEDs' information, the use of secondary data to measure INEDs' HC and SC provided limited evidence regarding the qualitative nature of the INEDs' knowledge, expertise, and network. Hence, future research can use primary information obtained via survey or interview with the INEDs in order to gauge their direct psychological information.

The third issue is related to the identification of RPTs, which by nature are diverse and complex transactions. Earlier research argued that the impact of RPTs on firm

outcomes is different according to how they are measured (Ariff & Hashim, 2014). Due to the complex nature of RPTs, this study focused only on the total amount of RPTs and the types of parties involved in RPTs. Consequently, the findings from this study did not completely capture the different nature of internal business dealings. In order to provide more valuable research in scrutinising RPTs, future studies should differentiate RPTs according to types of transaction and test them separately. This is consistent with the suggestion by Kohlbeck and Mayhew (2010) that the potential benefits or disadvantages of RPTs depend on the types of RPTs and parties involved in the dealing.

Fourth is the constructs chosen for INEDs' HC and SC. This study used three constructs to capture INEDs' HC and SC, namely INEDs' functional knowledge in accounting and finance, firm-specific knowledge, and external networking. Notably, INED's HC and SC are multidimensional concepts (Gayle, Golan, & Miller, 2015) that represent the directors' skills, knowledge, expertise, and network (Hillman & Dalziel, 2003; Johnson et al., 2013). Thus, using different constructs to measure INEDs' HC and SC could yield different results. Care is required in interpreting the findings from this study in light of the multidimensional and complex natures of measuring the INEDs' HC and SC.

Future research could refine and improve the existing constructs by employing a more comprehensive constructs of INEDs' HC and SC to better capture their skills, knowledge, expertise, and network. These constructs include the directors' industry expertise, international experience, education, and CEO experience (Chen et al., 2017; Johnson et al., 2013; Khanna et al., 2013). Future studies should also pay more

attention on the measurement issue of the constructs of INEDs' HC and SC. A study by Johnson et al. (2013) highlighted four measurements of directors' HC and SC that had been used in earlier research: (i) binary measures; (ii) count measures; (iii) ratio measures; and (iv) other measures such as composite index and heterogeneity index. Choosing a measurement technique is a multifaceted decision because a construct can be measured using multiple approaches. Therefore, future studies need to operationalise the focal construct consistently (Johnson et al., 2013).

The fifth limitation is the usage of theory whereby this study implemented the agency, resource dependence, human capital, and social capital theories to explain the monitoring and advising roles of INEDs. However, none of these theories could explain the results of this study. Thus, future studies may adopt and integrate other theories such as information processing and institutional theories (Hillman & Dalziel, 2003; Johnson et al., 2013; Kim, 2007; Khanna et al., 2013) to better understand the role of INEDs as corporate monitor and resource provider, as well as to identify the factors influencing their effectiveness.

Sixth is the proxy used to measure firm performance. This study used accounting-based measure (i.e. ROA) as the main proxy to measure firm performance. However, some scholars argued that the net profit figure could be easily manipulated through aggressive accounting practices. Therefore, future study may consider using cash flow measurement to measure firm performance, as it is less subject to manipulation. Finally, the sixth limitation is concerned with cross-sectional study as the present study focused on data for the year 2013 only. Hence, the results should be interpreted with caution. This study could be extended using the panel data technique to better explain

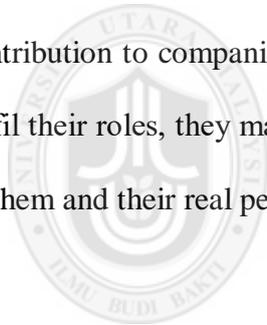
the effect of RPTs and the moderating effects of the proportion of INEDs and their HC and SC on RPTs-firm performance relationship.

6.6 Conclusion

Curbing and monitoring RPTs present a massive challenge for corporate governance reforms, especially in emerging economies. This study attempted to address this issue by using data from listed companies in Malaysia to examine the effect of RPTs on firm performance and the extent to which INEDs in Malaysia play their role in monitoring and advising RPTs. Unlike previous studies that mainly concentrated on structural board independence as a determinant of the board's ability, this study extended the research on INEDs by examining the moderating effects of their HC and SC on the relationship between RPTs and firm performance. Particularly, these capitals were represented by INEDs' functional knowledge in accounting and finance, INEDs' firm-specific knowledge, and INEDs' external networking. It was argued that taking a multiple theoretical approach could shed more light on the important questions regarding the governance and advising roles of INEDs in RPTs.

Regarding the effect of RPTs on firm performance, the findings were inconsistent with the research expectations. The results indicated that RPTs are not always used opportunistically by the insiders and thus, the findings supported the view that RPTs are efficient transactions. The results also suggested that RPTs with subsidiaries, associates, and joint ventures constitute a majority of the transactions that contribute to the positive relationship between RPTs and firm performance. Further analysis also suggested that the market participants perceived that RPTs would not harm the shareholders in many cases.

The unexpected results regarding the moderating effects of the proportion of INEDs and their HC and SC on RPTs-firm performance relationship indicated that INEDs play a limited role in RPTs. The findings raise question as to whether their roles in RPTs have been overemphasized or INEDs may be facing some barriers such as limited time commitment, information asymmetries, and cultural effect that hinder them from performing their roles effectively. This suggests that any efforts undertaken by the Malaysian government to strengthen the roles of INEDs should focus on the “substance” rather than “form”. In other words, the evidence implies that, instead of focusing on increasing board’s independence, regulators and policy makers should take into account the barriers that may prevent them from providing meaningful contribution to companies. In the absence of a conducive environment for INEDs to fulfil their roles, they may be facing an “expectation gap” between what are expected of them and their real performance.



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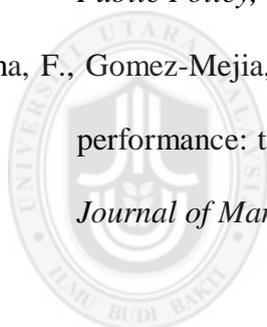
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APPENDIX A

LIST OF SAMPLE COMPANIES

1	BINA DARULAMAN	37	JERASIA CAPITAL
2	DKLS INDUSTRIES	38	JT INTERNATIONAL
3	FAJARBARU BUILDER GROUP	39	KHIND HOLDINGS
4	FUTUTECH	40	KOTRA INDUSTRIES
5	GABUNGAN AQRS	41	LAY HONG
6	GAMUDA	42	LII HEN INDUSTRIES
7	HOCK SENG LEE	43	MAXWELL INTERNATIONAL
8	IJM CORPORATION	44	MULTI SPORTS HOLDINGS LTD
9	JAKS RESOURCES	45	NEW HOONG FATT HOLDINGS
10	KIMLUN CORPORATION	46	NI HSIN RESOURCES
11	PESONA METRO HOLDINGS	47	ORIENTAL HOLDINGS
12	PRINSIPTEK CORPORATION	48	PADINI HOLDINGS
13	SYCAL VENTURES	49	PCCS GROUP
14	TRC SYNERGY	50	POH KONG HOLDINGS
15	TRIPLC	51	PPB GROUP
16	TSR CAPITAL	52	REX INDUSTRY
17	ZECON	53	SINARIA CORPORATION
18	AMTEK HOLDINGS	54	SPRITZER
19	APEX HEALTHCARE	55	SYF RESOURCES
20	APOLLO FOOD HOLDINGS	56	TAFI INDUSTRIES
21	ASIA BRANDS	57	TAN CHONG MOTOR HOLDINGS
22	BIOSIS GROUP	58	TEO SENG CAPITAL
23	BONIA CORPORATION	59	TOMEI CONSOLIDATED
24	C.I. HOLDINGS	60	TPC PLUS
25	CCK CONSOLIDATED HOLDINGS	61	UMW HOLDINGS
26	CHEE WAH CORPORATION	62	UPA CORPORATION
27	EMICO HOLDINGS	63	WANG-ZHENG XINGQUAN INTERNATIONAL
28	EURO HOLDINGS	64	SPORTS HOLDINGS LIMITED
29	EUROSPAN HOLDINGS	65	Y.S.P.SOUTHEAST ASIA HOLDING
30	FEDERAL FURNITURE HOLDINGS (M)	66	YEE LEE CORPORATION
31	FORMOSA PROSONIC INDUSTRIES	67	YOONG ONN CORPORATION
32	FRASER & NEAVE HOLDINGS	68	ZHULIAN CORPORATION
33	GOLDIS	69	GRAND CENTRAL ENTERPRISES
34	HONG LEONG INDUSTRIES	70	LANDMARKS
35	HUAT LAI RESOURCES	71	ABM FUJIYA
36	HWA TAI INDUSTRIES	72	AE MULTI HOLDINGS

Continued

73	AJIYA	109	HIL INDUSTRIES
74	ANCOM	110	HO WAH GENTING
75	A-RANK	111	IMASPRO CORPORATION
76	ASTRAL SUPREME	112	INGRESS CORPORATION
77	B.I.G. INDUSTRIES	113	JOHORE TIN
78	BOUSTEAD HEAVY INDUSTRIES	114	KECK SENG (MALAYSIA)
79	BOX-PAK (MALAYSIA)	115	KIAN JOO CAN FACTORY
80	BP PLASTICS HOLDING	116	KNM GROUP
81	BRIGHT PACKAGING INDUSTRY	117	KOMARKCORP
82	CB INDUSTRIAL PRODUCT HOLDING	118	KOSSAN RUBBER INDUSTRIES
83	CENTRAL INDUSTRIAL CORPORATION	119	KUMPULAN H & L HIGH-TECH
84	CHINA AUTOMOBILE PARTS HOLDING	120	KUMPULAN POWERNET
85	CME GROUP	121	KYM HOLDINGS
86	CN ASIA CORPORATION	122	LCTH CORPORATION
87	CONCRETE ENGINEERING PRODUCTS	123	LEADER STEEL HOLDINGS
88	CSC STEEL HOLDINGS	124	LEWEKO RESOURCES
89	CYL CORPORATION	125	LION CORPORATION
90	DELLOYD VENTURES	126	LUSTER INDUSTRIES
91	DENKO INDUSTRIAL CORPORATION	127	MALAYSIA SMELTING
92	D'NONCE TECHNOLOGY	128	MALAYSIA STEEL WORKS (KL)
93	DOLOMITE CORPORATION	129	MAXTRAL INDUSTRY
94	DRB-HICOM	130	METROD HOLDINGS
95	DUFU TECHNOLOGY CORP.	131	MIECO CHIPBOARD
96	EG INDUSTRIES	132	MINETECH RESOURCES
97	EKSONS CORPORATION	133	NARRA INDUSTRIES
98	EP MANUFACTURING	134	NWP HOLDINGS
99	FAVELLE FAVCO	135	PENSONIC HOLDINGS
100	FIBON	136	PETRONAS GAS
101	FOCUS LUMBER	137	RAPID SYNERGY
102	GLOBALTEC FORMATION	138	RUBBEREX CORPORATION (M)
103	GOH BAN HUAT	139	SAM ENGINEERING & EQUIPMENT
104	GOLSTA SYNERGY	140	SARAWAK CABLE SARAWAK CONSOLIDATED
105	GSB GROUP	141	INDUSTRIES
106	HALEX HOLDINGS	142	SEACERA GROUP
107	HEVEABOARD	143	SEREMBAN ENGINEERING
108	HIBISCUS PETROLEUM	144	SINO HUA-AN INTERNATIONAL

Continued

145	SKP RESOURCES	181	UNITED MALACCA
146	SLP RESOURCES	182	A & M REALTY
147	SMIS CORPORATION	183	AMCORP PROPERTIES
148	SOUTHERN STEEL	184	BERTAM ALLIANCE
149	STONE MASTER CORPORATION	185	DAMANSARA REALTY
150	SUCCESS TRANSFO	186	ENCORP
151	SUPPORTIVE INTERNATIONAL	187	GRAND HOOVER
152	TAS OFFSHORE	188	I-BERHAD
153	TECNIC GROUP	189	IJM LAND
154	TEKALA CORPORATION	190	KELADI MAJU
155	TIEN WAH PRESS HOLDINGS	191	KSL HOLDINGS
156	TURIYA	192	LAND & GENERAL
157	UCHI TECHNOLOGIES	193	LBI CAPITAL
158	VTI VINTAGE	194	LBS BINA GROUP
159	WHITE HORSE	195	LIEN HOE CORPORATION
160	WONG ENGINEERING CORPORATION	196	MAGNA PRIMA
161	YI-LAI	197	MALAYSIA AICA
162	YLI HOLDINGS	198	MALAYSIA PACIFIC CORPORATION
163	YOKOHAMA INDUSTRIES	199	MKH
164	LINGKARAN TRANS KOTA HOLDINGS	200	MUI PROPERTIES
165	SILK HOLDINGS	201	NAIM HOLDINGS
166	DUTALAND	202	ORIENTAL INTEREST
167	FAR EAST HOLDINGS	203	OSK PROPERTY HOLDINGS
168	GENTING PLANTATIONS	204	PERDUREN (M) BERHAD
169	GOPENG BERHAD	205	PETALING TIN BERHAD
170	INNOPRISE PLANTATIONS	206	PJ DEVELOPMENT HOLDINGS
171	KLUANG RUBBER COMPANY	207	SELANGOR DREDGING
172	KRETAM HOLDINGS	208	SHL CONSOLIDATED
173	KWANTAS CORPORATION	209	SYMPHONY LIFE
174	MHC PLANTATIONS BHD.	210	TA GLOBAL
175	RIVERVIEW RUBBER ESTATES	211	TAHPS GROUP
176	SARAWAK OIL PALMS	212	TIGER SYNERGY
177	SARAWAK PLANTATION	213	TRINITY CORPORATION
178	TDM BERHAD	214	TROPICANA CORPORATION
179	TSH RESOURCES	215	UEM SUNRISE
180	UNICO-DESA PLANTATIONS	216	Y&G CORPORATION

Continued

217	SONA PETROLEUM BERHAD	248	DIALOG GROUP
218	AMTEL HOLDINGS	249	EASTLAND EQUITY
219	CBSA BERHAD	250	EDEN INC. BERHAD
220	D&O GREEN TECHNOLOGIES	251	EFFICIENT E-SOLUTIONS
221	DIGISTAR CORPORATION	252	EITA RESOURCES
222	ELSOFT RESEARCH	253	EMAS KIARA INDUSTRIES
223	EXCEL FORCE MSC	254	FIAMMA HOLDINGS
224	GLOBETRONICS TECHNOLOGY	255	GEORGE KENT (MALAYSIA)
225	KESM INDUSTRIES	256	HARBOUR-LINK GROUP
226	MALAYSIAN PACIFIC INDUSTRIES	257	IHH HEALTHCARE
227	THETA EDGE	258	INTEGRATED LOGISTICS
228	VITROX CORPORATION	259	INTEGRAX
229	WILLOWGLEN MSC	260	KAMDAR GROUP (M) BERHAD
230	AEON CO. (M) BHD	261	KBES BERHAD
231	AIRASIA X BERHAD	262	KELINGTON GROUP BERHAD
232	AMWAY (MALAYSIA) HOLDINGS	263	KNUSFORD BERHAD
233	ASTRO MALAYSIA HOLDINGS	264	KPJ HEALTHCARE
234	ATLAN HOLDINGS	265	KPS CONSORTIUM
235	AYS VENTURES	266	LFE CORPORATION
236	BERJAYA CORPORATION	267	LUXCHEM CORPORATION
237	BERJAYA MEDIA	268	MALAYSIAN AIRLINE SYSTEM
238	BHS INDUSTRIES	269	MALAYSIAN BULK CARRIERS
239	BORNEO OIL BERHAD	270	MASTERSKILL EDUCATION GROUP
240	BOUSTEAD HOLDINGS	271	METRONIC GLOBAL
241	CENTURY LOGISTICS HOLDINGS	272	MY E.G. SERVICES NATIONWIDE EXPRESS COURIER SERVICES
242	CHEETAH HOLDINGS	273	NCB HOLDINGS
243	COMPLETE LOGISTIC SERVICES	274	OCB BERHAD
244	COMPUGATES HOLDINGS	275	OGAWA WORLD BERHAD
245	CYCLE & CARRIAGE BINTANG	276	OLDTOWN BERHAD
246	DAYA MATERIALS BERHAD	277	OLYMPIA INDUSTRIES
247	DESTINI BERHAD		

Continued

279	PANSAR BERHAD
280	PANTECH GROUP HOLDINGS BERHAD
281	PARKSON HOLDINGS BERHAD
282	PDZ HOLDINGS BHD
283	PHARMANIAGA BERHAD
284	PRESTARIANG BERHAD
285	PROGRESSIVE IMPACT CORPORATION
286	SALCON BERHAD
287	SAMCHEM HOLDINGS BERHAD
288	SAPURAKENCANA PETROLEUM
289	SCOMI ENERGY SERVICES BHD
290	SCOMI GROUP BERHAD
291	SHIN YANG SHIPPING CORPORATION
292	SIME DARBY BERHAD
293	STAR PUBLICATIONS
294	SYMPHONY HOUSE BHD
295	TANJUNG OFFSHORE BERHAD
296	TELEKOM MALAYSIA BERHAD
297	TH HEAVY ENGINEERING BERHAD
298	THE STORE CORPORATION BERHAD
299	TURBO-MECH BERHAD
300	WARISAN TC HOLDINGS BERHAD

APPENDIX B

Types of Related Parties

Description

Related entities include the following:

- Transaction with subsidiaries
- Transaction with associates
- Transaction with joint ventures

Related persons include the following:

- Transaction with directors
 - Transaction with major shareholders
 - Transaction with persons connected with directors or major shareholders
 - Transactions with director related entities
-



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APPENDIX C

An Example of Related Party Transactions Classifications

The partial information is extracted from the annual report of ANCOM Berhad for the financial year 2013:

36. RELATED PARTY DISCLOSURES

(a) Identities of related parties

Parties are considered to be related to the Group if the Group has the ability, directly or indirectly, to control the party or exercise significant influence over the party in making financial and operating decisions, or vice versa, or where the Group and the party are subject to common control or common significant influence. Related parties could be individuals or other entities.

The Company has controlling related party relationship with its direct and indirect subsidiaries as disclosed in Note 41 to the financial statements.

(b) In addition to the transactions detailed elsewhere in the financial statements, the Group and the Company had the following transactions with related parties during the financial year:

	2013 RM'000	2012 RM'000
Sales to a company in which a Director of the Company has substantial indirect shareholding	4,053	-
Purchase from a company in which a Director of the Company has substantial indirect shareholding	641	-
Sales to associates: Nufarm Technologies (Malaysia) Sdn. Bhd.	-	70
Magiqads Sdn. Bhd	-	89
Purchases from associates: Magiqads Sdn. Bhd	2,152	1,987
Services rendered by a company in which certain Directors of the Company have substantial indirect shareholding	-	2,300
Professional legal fees paid to a firm of which a Director of the Company is a Partner	1,118	1,143
Insurance premium paid to a company in which a Director of the Company has a substantial indirect shareholding	28	56

Transactions with
Related Entities

Transactions with
Related Persons

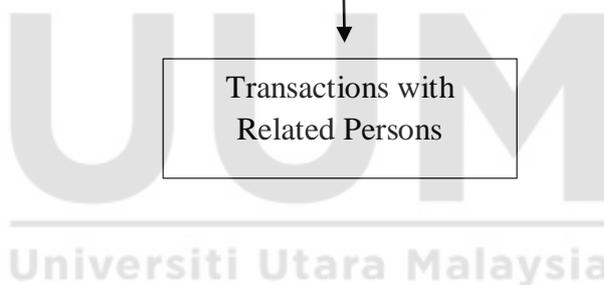
Appendix C Continued

(d) Compensation of key management personnel

Key management personnel are those persons having the authority and responsibility for planning, directing and controlling the activities of the entity, directly and indirectly, including any Director (whether executive or otherwise) of the Group.

The remuneration of Directors and other key management personnel of the Group and of the Company during the financial year was as follows:

	2013	2012
	RM'000	RM'000
Short term employee benefits	28,596	30,939
Contributions to defined contribution plan	1,396	1,917
Benefits-in-kind	1,651	261
	31,643	33,117



APPENDIX D

VIF Tests

VIF for Table 5.3

	VIF
RPTs	1.091
BIG4	1.264
BSIZE	1.196
FSIZE	1.723
LEV	1.172
CSOWN	1.090
CSTYPE	1.503
MOWN	1.317

Notes: VIF less than 10 indicates that there is no multicollinearity problem (Gujarati, 2003)



VIF for Table 5.3a

	VIF
RPTRE	1.044
RPTRP	1.077
BIG4	1.264
BSIZE	1.196
FSIZE	1.729
LEV	1.172
CSOWN	1.095
CSTYPE	1.505
MOWN	1.318

Notes: VIF less than 10 indicates that there is no multicollinearity problem (Gujarati, 2003)

Appendix D Continued

VIF for Table 5.4

	VIF	VIF
RPTs	1.095	
RPTRE		1.078
RPTRP		1.094
INEDPROP	1.258	1.283
BIG4	1.271	1.272
BSIZE	1.408	1.421
FSIZE	1.739	1.748
LEV	1.193	1.199
CSOWN	1.128	1.136
CSTYPE	1.504	1.507
MOWN	1.352	1.356

Notes: VIF less than 10 indicates that there is no multicollinearity problem (Gujarati, 2003)

VIF for Table 5.5

	VIF	VIF
RPTs	1.096	
RPTRE		1.045
RPTRP		1.089
INEDFUNK	1.087	1.088
BIG4	1.264	1.265
BSIZE	1.219	1.219
FSIZE	1.726	1.733
LEV	1.172	1.179
CSOWN	1.094	1.100
CSTYPE	1.516	1.523
MOWN	1.343	1.344

Notes: VIF less than 10 indicates that there is no multicollinearity problem (Gujarati, 2003)

Appendix D Continued

VIF for Table 5.6

	VIF	VIF
RPTs	1.105	
RPTRE		1.049
RPTRP		1.086
INEDSPEK	1.088	1.143
BIG4	1.299	1.299
BSIZE	1.199	1.202
FSIZE	1.733	1.739
LEV	1.180	1.183
CSOWN	1.090	1.096
CSTYPE	1.504	1.509
MOWN	1.319	1.320

Notes: VIF less than 10 indicates that there is no multicollinearity problem (Gujarati, 2003)

VIF for Table 5.7

	VIF	VIF
RPTs	1.116	
RPTRE		1.077
RPTRP		1.082
INEDNET	1.160	1.160
BIG4	1.297	1.297
BSIZE	1.206	1.208
FSIZE	1.767	1.775
LEV	1.184	1.189
CSOWN	1.098	1.104
CSTYPE	1.511	1.522
MOWN	1.320	1.321

Notes: VIF less than 10 indicates that there is no multicollinearity problem (Gujarati, 2003)