CAN INDEPENDENT DIRECTORS PREVENT ABUSIVE RELATED PARTY TRANSACTIONS?

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Abstract

Abusive related party transactions (RPTs) have been highlighted as one of the major concerns after the 1997 Asian financial crisis. Since the crisis, many reforms to the law and regulation systems have been taken by the Asian countries, including Malaysia, to curb abusive RPTs. A key problem with RPTs is that the transactions are influenced by the relationship between parties involved in the transactions. Many abusive RPTs cases in Asia, such as Satyam Computers Ltd (India), Transmile Group Berhad (Malaysia), Asia Pulp and Paper (Indonesia) and others, demonstrate how these transactions ultimately benefited the top management and controlling shareholders. Therefore, an issue of concern with regard to this issue is a mechanism that can constrain the insiders from engaging in abusive RPTs. Many jurisdictions have placed greater reliance on the institution of independent directors (INEDs) to protect the interest of shareholders. INEDs, being independent from the influence of the insiders, are expected to balance and limit the strong power and incentives of managers and controlling shareholders, thereby effectively prevent abusive RPTs. However, prior studies provide mixed results on whether INEDs are effective monitors. We argue that for INEDs to function effectively, it is not enough just to be independent. Certain INEDs attributes, namely the composition of INEDs, their financial expertise, INEDs tenure and the presence of women INEDs, will influence INEDs’ governance effectiveness. Therefore, this paper aims to review the role of INEDs in monitoring RPTs. It firstly discusses on the issues surrounding RPTs. Further, this paper reviews the regulatory and corporate governance reforms relating to RPTs and the institution of INEDs, with specific attention to the Malaysian context. Based on prior literature, this paper then highlights on how INEDs composition, financial expertise, INEDs tenure and the presence of women INEDs can enhance their monitoring role. The final section concludes the paper.

Keywords: Related party transactions, Independent directors, Directors tenure.

1 INTRODUCTION

Related party transactions (RPTs hereafter) refer to the transfer of resources, services or obligations between related parties, regardless of whether a price is charged or not, 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). These transactions are a common business feature as firms conduct their business and operations through subsidiaries, associates, joint ventures or affiliates. However, abusive RPTs cases in Asia, including Satyam Computers Ltd (India), Transmile Group Berhad (Malaysia), Asia Pulp and Paper (Indonesia) and others, demonstrate how RPTs ultimately benefited the insiders (i.e. top management and controlling shareholders). The Organisation for Economic Co-operation and Development (OECD) termed these transactions as “abusive” RPTs, where a controlling party of a firm enters into a transaction that is detrimental to non-controlling shareholders (OECD, 2009, p.3).

Abusive RPTs have received considerable attention after the 1997 Asian financial crisis and the widespread of high-profile corporate scandals, such as Enron and WorldCom. Poor corporate governance was identified as one of the major contributing factors to the occurrence of many abusive RPTs cases. Empirical evidence shows that RPTs are the most common ingredient used by the controlling parties in “cooking the books” activities, particularly in companies with weak governance and monitoring mechanisms (Cheung, Jing, Lu, Rau and Stouraitis, 2009, pp. 372-393; Dahya, Dimitrov and McConnell, 2008, pp. 73-100; Gordon,
For instance, related-party sales transactions have been used by Transmile Group Bhd, once the darling of the Malaysian aviation industry, to window dress its financial performance (Table 1). The potential problem with RPTs is that their economic substance may differ from their legal form. RPTs might not be undertaken at market prices, but rather are influenced by the relationships between the two parties to a 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. Abusive RPTs eventually may lead to expropriation of minority shareholders. The adverse impact of abusive RPTs cannot be underestimated. They have been proven to reduce earnings quality (Aharony, Wang and Yuan, 2010, pp. 1-26), reduce firm value (Gordon et al., 2004) and lead to 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, have erased billions of dollars of shareholder values and eroded investors’ confidence in the capital markets (CFA, 2009).

### Table 1. Cooking the Books through Related Party Transactions: The case of Transmile Group Bhd

<table>
<thead>
<tr>
<th>Transmile Group Bhd (Malaysia)</th>
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<tbody>
<tr>
<td><strong>The corporate kitchen</strong></td>
</tr>
<tr>
<td>• Incorporated in 1993</td>
</tr>
<tr>
<td>• Listed on the second board of Bursa Malaysia in June 1997</td>
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<tr>
<td>• Principal activity: air cargo service provider</td>
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<tr>
<td><strong>Master chef</strong></td>
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<tr>
<td>• Former CEO</td>
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<td>• Former CFO</td>
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<td>• Former executive director</td>
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<td>• Two former independent directors</td>
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<tr>
<td><strong>Recipe</strong></td>
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<tr>
<td>• Overstated its revenue for 2004-2005 by a total of RM522 million</td>
</tr>
<tr>
<td>• No supporting documents for payments of RM341 million made for the purchase of property, plant and equipment</td>
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<tr>
<td>• Related-party sales transactions in which the subsidiary owed to Transmile more than RM103 million</td>
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<tr>
<td><strong>Finished dish</strong></td>
</tr>
<tr>
<td>• Former directors were compounded RM1.9 million</td>
</tr>
<tr>
<td>• Former independent directors were jailed one year and fined RM300,000</td>
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<tr>
<td>• Share price dropped from RM14.40 (3rd January 2007) to RM4.64 (3rd July 2007) and below RM0.50 (since March 2010)</td>
</tr>
<tr>
<td>• Delisted from Bursa Malaysia on 24th May 2011</td>
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</tbody>
</table>

Source: Abdul Hamid, Shafie, Othman, Wan Hussin and Fadzil (2013, pp. 179-186)

Companies in emerging markets, including Malaysia, are more prone to engage in RPTs because of their concentrated ownership structure. A large number of organizations are run either by families or the state. In family-controlled firms, nearly all of top management positions are occupied by members of the family, while in state-controlled firms, the positions are dominated by political appointees (CFA, 2009). By holding these positions, the controlling parties have the ability to exercise 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 are controlled by a single individual or wealthy families through a pyramidal structure. In such pyramidal business groups, the ultimate controlling shareholders exert control over the group members via a chain of ownership relations. According to Bebchuk, Kraakman and Triantia (2000, pp. 295-315) and Riyanto and Toolsema (2008, pp. 2178-2187), this pyramidal structure enabled 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 an incentive and ability to divert firm resources for their private benefits instead of sharing them with the other shareholders.

A major area of concern with regard to this issue is a mechanism that can constrain the controlling parties from engaging in transactions that might abuse minority shareholders. Since RPTs are diverse and often complex (Gordon et al., 2004), curbing and monitoring of these transactions represent a big challenge for all countries in the world. Even though some mechanisms exist to monitor RPTs in many jurisdictions, abusive RPTs are still pervasive. This problem was largely blamed on the failure of the boards of directors to fulfill their fiduciary duties to shareholders. Consequently, the concept of “board independence” has emerged and
become a priority of many corporate governance reforms. Independent directors (INEDs), who are independent from the influence of the management and major shareholders, are seen as an essential tool to promote good corporate governance and hence, mitigate the risk of minority expropriation. With respect to RPTs, INEDs play a crucial role in reviewing and approving the terms and conditions of RPTs to prevent abuse (OECD, 2012). The importance of INEDs in monitoring RPTs is also recognized by the OECD. For instance, the OECD Principle VI.D.6 recommends that the board should fulfill certain key functions, including “…monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions” (OECD 2004, p. 24). The OECD subsequently released its 2009 “Guide on Fighting Abusive Related Party Transactions”. The guide addresses the role of INEDs and recommends that they “…should play a central role in monitoring related party transactions, such as designing board approval procedures, conducting investigations and having the possibility for obtaining advice from independent experts…” (OECD 2009, p. 8).

Numerous studies had been conducted to examine the effectiveness of implementing INEDs, but the results are inconclusive. In fact, the recent 2007-2008 global financial crisis revealed serious shortcomings in the INEDs system. Again, INEDs were partly blamed for the major failures of “checks and balances” (Ringe, 2013). The crisis has led many to question whether INEDs add value to the firms. The scenario motivates us to explore current developments regarding the RPTs and INEDs in Malaysia, to review the literature on the monitoring role of INEDs and to make propositions based on the literature on how INEDs can contribute in preventing abusive RPTs. This paper is structured as follows: Section 2 discusses the regulatory and corporate governance reforms relating to RPTs and the institution of INEDs in Malaysia, Section 3 reviews the literature on the monitoring role of INEDs with specific attention given to the importance of INEDs composition, financial expertise, tenure and gender diversity in enhancing the effectiveness of monitoring by INEDs. Research propositions are also presented in Section 3, and finally, Section 4 concludes the paper.

2 INSTITUTIONAL BACKGROUND

2.1 The Legal And Regulatory Framework For RPTs In Malaysia

Malaysian Financial Reporting Standards (MFRS), the Companies Act 1965 and Bursa Malaysia Listing Requirements (BMLR) are three main sources of regulations on RPTs in Malaysia. MFRS 124 Related Party Disclosures, contains guidelines on disclosure of RPTs. Part E of Chapter 10 of the BMLR, lay down requirements that need to be complied with respect of RPTs entered by a publicly listed company (PLC) or its subsidiaries. Sections 131, 132E, 133 and 133A of the Companies Act 1965 provide detailed provisions regarding to related party dealings.

2.1.1 MFRS 124 Related Party Disclosures

MFRS 124 requires disclosure of related party relationships, transactions and outstanding balances, including commitments, in the entity’s financial statements, which include at least, the amount of the transactions, the amount of outstanding balances, including commitments, provisions for doubtful debts related to the amount of outstanding balances and the expense recognised during the period in respect of bad or doubtful debts due from related parties. These disclosures are required to be made separately for each category of related party in order to provide a more comprehensive 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 or not. This information is necessary for users to understand the potential effect of the relationship on the financial statements.

2.1.2 The Companies Act 1965

The Companies Act 1965 sets out the legal basis on which companies are established, operated and administrated. Since its enactment in 1965, the Act has been amended 35 times and the most recent being the Companies (Amendment) Act 2007 (Act A1299). The amendment, which introduced 24 new clauses in the Companies Act 1965, came into force on 15th August 2007. In particular, the relevant provisions relating to RPTs are found in Sections 131, 131A, 132E, 133 and 133A of the Act.

Section 131 deals with disclosure of interest (whether directly or indirectly) in contracts or proposed contract with a company by a director at the board meeting. The 2007 amendment inserted a new clause, Section 131(7A), which provides that the interest of a spouse and a child, including an adopted child or stepchild is included in the interests that a director must disclose under Section 131. Moreover, a new section 131A was introduced to prohibit the interested director from voting on or participating in any board meetings. The amendment, Section 131A, aims to prevent interested directors from voting or participating in transactions where they have a personal interest.
discussion on the contract or proposed contract when it is being considered.

The new section 132E is another amendment that substitutes the existing Section 132G. With this new amendment, prior approval is required in General Meeting for a company to carry into effect any arrangement or transaction to acquire or to dispose of shares or non-cash assets of the requisite value of the director or substantial shareholder or connected persons. Prior to 15th August 2007, there is no restriction on voting by the director and substantial shareholders interested in the property transactions, substantial shareholders are not included and the transaction is voidable and can be ratified by the company within a reasonable period.

Sections 133 and 133A are two sections in the Companies Act 1965 that 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 provide any security in connection with a loan made to such director or 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.

2.1.3 Bursa Malaysia Listing Requirements

Bursa Malaysia is the main regulator of the Malaysian stock market. It is responsible for the regulation and operation of all securities trading activities in Malaysia. All listed issuers must comply with its Listing Requirements. Part E of Chapter 10 of the Listing Requirements specifically deals with RPTs. In these requirements, RPT means a transaction entered into by the listed issuer or its subsidiaries which involves the interest, direct or indirect, of a related party (Part E, Section 10.02 para k). Meanwhile, recurrent related party transaction (RRPT) 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 listed issuer or its subsidiaries (Part E, Section 10.02 para j). Related party is defined as a director, major shareholder or person connected with such director or major shareholder (Part A, Chapter 1, Section 1.01).

2.2 Independent Directors In Malaysia

In Malaysia, the concept of INEDs has received substantial attention from regulators, particularly after the 1997 Asian financial crisis. As lessons learnt from the crisis, numerous initiatives have been taken by the Malaysian government to strengthen the role of INEDs. For instance, The Malaysian Code on Corporate Governance (MCCG) was issued by the Finance Committee on Corporate Governance (FCCG) in March 2000. The Code recommends that as a best practice, the board should include a balance members with at least one third of the membership of the board should comprise of INEDs. This is to ensure that the board’s decision making is not dominated by a certain party.

The Code 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 Code mainly focused on improving the quality of the board of PLCs and strengthening the role of the audit committee (AC). The code strongly recommended that the members of AC comprised of non-executive directors who are financially literate and at least one should be a member of an accounting association or body.

The recent MCCG 2012, which supersedes the 2007 Code, is part of a key deliverable 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 are critical to the effectiveness of the board’s monitoring function. Thus, the 2012 Code focused, among other, on the independence of INEDs. The board is encouraged to undertake an annual assessment of 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. Additionally, the Code also requires a board to establish a formal policy on boardroom diversity to ensure that women candidates are included in its recruitment exercise. The corporate board is also required to explicitly disclose in the annual report, its gender diversity policies and along with the measures taken to achieve the targets.

To summarize, there are a few important attributes of the INEDs that have been emphasized in corporate governance reforms, namely the composition of INEDs, their financial expertise, length of tenure and gender diversity. Those attributes are perceived to improve the board’s efficacy.
3 LITERATURE REVIEW AND RESEARCH PROPOSITIONS

Studies have reported that RPTs are a major channel through which controlling shareholders divert corporate resources for personal benefits, at a cost of non-controlling shareholders. Their incentives for diverting corporate resources are greater in countries with weak investor protection (Dahya et al., 2008, pp. 73-100). Not surprisingly, such diversion reduces firm value and, at worst hinders the development of financial market and economic growth. The OECD 2008 “Asian Roundtable on Corporate Governance” identifies these abusive RPTs as one of the biggest corporate governance challenges faced by many Asian businesses.

As argued by Dahya and McConnell (2009, pp. 37-60), the appointment of directors (i.e. INEDs) with no connection to the controlling owner can be a powerful tool for restricting resource diversion and transfer of firm value from minority shareholders. They can reduce resource diversion by monitoring the terms of RPTs and ensure that these dealings are not carried out against the interest of minority shareholders. Corporate Governance Guide (CGG) 2009 highlights that “an independent director is especially important in areas where the interests of management, the company and the shareholders diverge, such as executive performance and remuneration, related party transactions and audit” (CGG 2009, p. 21). In fact, 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 dealings are carried out on normal commercial terms and not detrimental to the interests of the company or its minority shareholders (CGG, 2009).

Effective functioning of INEDs is essential in reducing agency costs and monitoring corporate activities, as to safeguard the interest of minority shareholders. In order for the INEDs to function effectively, it is not enough to just be independent. Rather, as suggested by prior studies, the composition of INEDs, their financial expertise, INEDs tenure and the presence of women in INEDs are among INEDs attributes that can enhance their oversight role.

3.1 Composition of Independent Directors

A balanced board is important for the board to function effectively. To be effective, the MCCG 2007 proposes that “the board should include a balance of executive directors and non-executive directors (including independent non-executives) such that no individual or small group of individuals can dominate the board’s decision making” (MCCG 2007, p. 7). The institution of INEDs has been recognised as one of the mechanisms for protecting the interest of minority shareholders (OECD, 2004). Nguyen and Nielsen (2010, pp. 550-567) had outlined three reasons why independent outside directors are expected to function as an effective monitor or advisor. First, they are not, or are less, subjected to potential conflicts of interest that reduce their monitoring capacity. Second, typically they also serve as experienced professionals in other firms or large organizations and therefore, care more about their reputations and careers. Third, INEDs also have technical expertise both in management and decision making.

In concentrated ownership structure, because the interests of controlling shareholders are not aligned with minority shareholders, therefore, the appointment of outside (or independent) directors, as opposed to inside directors, are viewed by minority shareholders as an objective monitor of the firm (Kim, Kitsabunarat-Chatjutharam and Nofsinger, 2007, pp. 859-880). For RPTs cases, there is an expectation that INEDs scrutinise RPTs to ensure that the dealings are fair, reasonable and are in the best interest of all shareholders. There is an argument that independence from insiders alone, does not guarantee a good monitor. Prior literature suggested that the composition (proportion) of INEDs is one of the attributes of an effective monitor. According to Goodstein and Boeker (1991, pp. 306-330), the composition of the board of directors is an important determinant of its ability to carry out its governance responsibilities. Prior research found out that outsider-dominated boards are more likely to increase firm value (McKnight and Mira, 2003), reduce corporate fraud (Beasley, 1996, pp. 443-465), increase voluntary disclosures (Cheng and Courtney, 2006, pp. 262-289) and reduce earnings management (Jaggi, Leung and Gul, 2007, pp. 281-300). Overall, these studies support the notion that INEDs lead to a stronger board.

Studies that focus on RPTs also provided evidence that INEDs play an important role in monitoring RPTs. For instance, using data from 22 countries, Dahya et al. (2008, pp. 73-100) found out that a higher fraction of INEDs is associated with a higher firm value. Such correlation is stronger in countries with weaker legal protection for shareholders. Furthermore, they found a significant negative relationship between the proportion of INEDs and the likelihood of RPTs. A study by Chien and Hsu (2010) also documented a
marginally positive moderating effect of corporate governance mechanisms (proxied by Big-N CPA firms and independent boards and supervisors) on RPTs-firm performance. Their findings suggested that good corporate governance mechanisms transfer RPTs from “conflict of interest” to “efficient transactions”.

Due to the important role played by INEDs as corporate monitors, publicly traded corporations worldwide had been forced to increase representation of INEDs on the board (Dahya and McConell, 2005, pp. 37-60). According to Dahya and McConell (2005, pp. 37-60), between 1993 and 2000, at least 18 countries had published guidelines proposing minimum participation of INEDs. The premise underlying the movement towards greater participation of outside directors is that outsider-dominated boards will lead to different and, perhaps, better decisions than boards dominated by inside directors. The shift towards a more prominent role for outside directors can be traced to the Cadbury Report issued in 1992 in the U.K. Among other, the Cadbury Report recommended publicly-traded U.K. companies to have a minimum of three outside directors. In line with this, the Bursa Malaysia Listing Requirements require a minimum of two (2) or one third (1/3) of the board of the PLCs, whichever is higher, are INEDs. This is to ensure that objectivity in decision-making of the board is achieved and that no single party can dominate such decision-making in the company.

Based on the above discussion, we predict that boards dominated by INEDs would result in better monitoring of RPTs, making RPTs to be conducted for efficiency purposes and at the same time restraining harmful RPTs. Hence, this paper proposes that a higher proportion of INEDs may have a positive impact in mitigating potentially abusive RPTs.

3.2 Financial Expertise of Independent Directors

Many studies suggest that financial expertise among INEDs is associated with effective functioning of board monitoring. Being members of the audit committee, it is vital for INEDs to be equipped with an accounting background. Defond, Hann and Hu (2005, pp. 153-193) argued that accounting-specific expertise may be important for the members of the audit committee due to their numerous responsibilities that require a relatively high degree of accounting sophistication. A study by Defond et al. (2005, pp. 153-193) provided an 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 INEDs with financial expertise may enhance the quality of financial reporting process. For example, financial expertise on boards reduces the likelihood of fraud and earnings restatements (Agrawal and Chadha, 2005, pp. 37-406), more effective in mitigating earnings management (Carcello, Hollingsworth, Klein and Neil, 2006, pp. 351-373) and less likely to be associated with the occurrence of internal control problems (Krishnan, 2005, 649-675). A study by McMullen and Raghunandan (1996, pp. 67-75) 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 has a positive impact on a firm’s financial reporting quality. For instance, using a sample of firms from the 1995-1996 Association for Investment Management and Research (AIMR) financial reporting quality database, Felo, Krishnamurthy and Solieri (2003) found out that the fraction of audit committee members having expertise in accounting or financial management is positively related to financial reporting quality. This finding suggested that having more financial expertise on audit committees rather than simply requiring one expert on the audit committee may be beneficial to investors.

The need for more financial experts on boards has received much attention from regulators due to the increasing number of fraud cases. For instance, in July 2002, the United States adopted the Sarbanes Oxley Act (SOX), which applies to all companies listed on US stock markets. At the end of 2003, the New York Stock Exchange (NYSE), NASDAQ and the American Stock Exchange (AMEX) adopted new sets of corporate governance rules that apply to most of their listed companies (Agrawal & Chadha, 2005, pp. 371-406). One of their provisions requires a company to have a majority of INEDs on the board and that the board’s audit committee consists entirely of INEDs and has at least one member with financial expertise. This provision is based on the premise that boards’ members with experience in accounting or finance are more likely to be able to detect problems in financial reporting (Agrawal and Chadha, 2005, pp. 371-406). In Malaysia, the MCCG 2007 recommends that for the best practice, the board should establish an audit committee comprising of at least three members, a majority of whom are INEDs. All members of the audit committee should be non-executive directors and financially literate and at least one should be a member of an accounting association or body. These recommendations are mandated in the Listing Requirements of Bursa Malaysia Securities.

With regards to RPTs, one of the important roles of INEDs (being part of an audit committee) is to monitor

RPTs and ensuring that such transactions are conducted in the best interest of the company and its minority shareholders. Details of their duties have been discussed in the Corporate Governance Guide issued by Bursa Malaysia in 2009. 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 ensure that a proper and comprehensive framework for the identification, monitoring, evaluating, approving and reporting of RPTs is established. Therefore, to effectively fulfill these roles requires specialized and functional accounting knowledge.

RPTs are usually made through complicated transactions between the firm and its managers, directors, subsidiaries and major shareholders, making them a potential platform for insiders’ opportunistic behaviour. Pucek and Richards (2013) indicated that the complexity and risks associated with recognition and disclosure of RPTs are significant. Many RPTs have “substance over form” problems and some of them are embedded in documentation that is less clear or thorough than the documentation that ordinarily exists between unrelated parties. These provide opportunities for insiders to engage in abusive RPTs. In fact, RPTs have been associated with numerous accounting failures and fraud, such as Enron and Worldcom. Due to the complicated nature of RPTs, we, therefore, suggest that financial expertise (i.e. having a member who has sound skills in accounting and finance) rather than financial literacy (i.e. a member who has the ability to read and understand financial statements) seems to matter for effective functioning of INEDs. We expect that INEDs with financial expertise are more likely to constrain disadvantages RPTs. Therefore, this study proposes that a higher proportion of INEDs with financial expertise may have a positive impact in mitigating potentially abusive RPTs.

3.3 Tenure of Independent Directors

The U.S. Senate report on Enron (U.S. Senate, 2002) revealed that the board tenure is another shortcoming 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 suggested 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 have adopted 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.

Generally, there are two opposite views on long-tenured directors. On one hand, those who favour the limit of tenure for INEDs suggest that directors serving on boards for long periods of time may become less independent and objective. On the other hand, those who hold the opposite view argue that long tenure is a sign of a director’s commitment and expertise. Vafeas (2003, pp. 1043-1064) proposed two hypotheses regarding the impact of director’s tenure on the quality of board’s oversight, namely, management friendliness hypothesis and expertise hypothesis. The management friendliness hypothesis suggests that long-tenured directors are more likely to befriend management, and hence, less effective in monitoring the management. Alternatively, under the expertise hypothesis, directors with longer tenure have greater firm and industrial knowledge and, thereby, enable 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. Consistent with management friendliness hypothesis, Vafeas (2003, pp. 1043-1064) 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. This perspective is also supported by Rickling (2014, pp. 173-191) who found out that audit committee director tenure is positively associated with the likelihood of a firm repeatedly hold meeting or just beating analysts forecasts, and thus, support calls to limit the tenure of directors. In contrast, Liu and Sun (2010, pp. 176-189) demonstrated the negative relationship between the proportion of long-tenured directors and earnings management and thus, supporting the expertise hypothesis. Since there are two conflicting arguments on long-tenured directors, this paper proposes that INEDs tenure may have an impact on the potentially abusive RPTs.

3.4 Gender Diversity

There are many reasons highlighted in previous literature on why women should be on corporate boards. Existing evidence shows that women directors provide greater oversight and monitoring of managers’
actions and reporting. For instance, Gul, Srinidhi and Tsui (2008) showed that boards with at least one female director and with a higher proportion of female directors demand higher monitoring in the form of more audit effort, particularly in situations of high information asymmetry, complexity and ethical dilemma. The result is also similar for female non-executive directors’ presence and their proportion. Adams and Ferreira (2009, pp. 291-309) showed that female directors are more likely to take part in monitoring-related committees than male directors in 1024 publicly-traded US firms. Their findings suggested that gender-diverse boards allocate more effort to monitoring. Utilizing the US General Accounting Office (U.S. GAO 2002) report on the restatement, Abbott, Parker and Peter (2012, pp. 69-87) found a significant association between the presence of at least one woman on the board and a lower likelihood of restatement. The findings suggested that the presence of female board members can potentially contribute to the ability of the board to maintain an independent mental attitude, diminish the tendency of groupthink and enhance the monitoring of financial reporting.

The inclusion of women on boards can also lead to higher quality of decision-making. Because board decisions are mostly unstructured, involvements of women who are able to bring a diverse perspective are required for the board to access the consequences of their decisions better (Gul, Srinidhi and Ng, 2011, pp. 341-338). Female directors are more inclined to create a questioning culture (Selby, 2000, pp. 239-251), which in turn, lead to more in-depth discussion. They are likely to ask tough questions and demand direct and detailed answer (Konrad, Kramer and Erkut, 2008, pp. 145-164). Moreover, the presence of women on corporate boards brings new and different perspectives, skills and experiences and that leads to a better decision making. In addition, a study by Bart and McQueen (2013, pp. 93-99) demonstrated that women are more inclined to take into account the interest of multiple shareholders and tend to use cooperation, collaboration and consensus building more frequently and effectively so as to make sound decisions. This approach results in better performance for their companies.

The importance of gender balance of corporate boards is also recognised in Malaysia. For instance, in June 2012, the Malaysian government had approved a policy that set a target of having at least 30% women in senior decision-making positions and on corporate boards of Malaysian public listed companies (PLCs) by 2016. This policy was a continuation of a similar one set for the public sector in 2004, which has proven to be successful in increasing women’s representation at the decision-making level. In achieving the government’s policy target, the Ministry of Women, Family and Community Development (MWFC), through its agency, Institute for the Empowerment of Women (NIEW), has introduced the Women Directors’ Programme (WDP) to prepare potential and qualified women for directorship roles in Malaysian PLCs. Aside from the WDP initiative, NIEW had also created a comprehensive women directors registry that companies may refer to when searching for qualified women candidates to fill the board positions.

Given that prior literature demonstrated that the presence of women on boards enhances board independence, we posit that the presence of women INEDs may restrain the controlling shareholder from engaging in harmful RPTs by monitoring the term of such transactions. Hence, this study proposes that the presence of women INEDs may have a positive impact in mitigating potentially abusive RPTs.

4 CONCLUSION

RPTs are a common business deal among Malaysian companies. This can be associated with the economy of Malaysia, which is characterised by a relationship-based system or political connection. In fact, the ownership structure of Malaysian companies is highly concentrated where families and the government own significant ownership in many of the listed companies. Moreover, a substantial number of Malaysian listed companies belong to large business groups, where members are bound together by formal and/or informal ties. Such structure may result in the widespread use of RPTs and in fact, these transactions become part of every business group activity. However, abusive RPTs have garnered serious attention after the 1997 Asian financial crisis and corporate scandals, such as those involving Enron and WorldCom. The crisis and corporate scandals exposed the weaknesses in corporate governance practices and thus, provide strong incentive for controlling shareholders to expropriate minority shareholders. RPTs have been identified as the most frequent technique used by controlling shareholders to extract corporate resources from non-controlling shareholders. Consequently, the concept of “board independence” was introduced and become a priority of many corporate governance reforms.

The appointment of INEDs, who are independent from management, is seen as a powerful tool to restrict resource diversion by controlling shareholders. Increasing the independence of corporate directors is one of the main focuses on corporate governance reforms. INEDs composition, financial expertise, tenure and gender diversity are among the attributes of INEDs that may influence their independence and oversight role.
Since scarce research has been conducted in this area, this paper call for more studies addressing the impact of specific attributes of INEDs on corporate decision making, such as a decision to enter into a RPT.

**REFERENCE LIST**


