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**CORPORATE GOVERNANCE AND FIRM PERFORMANCE OF LISTED
COMPANIES IN MALAYSIA**

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Abstract

This study examines the relationship between corporate governance and firm performance for a sample of 813 listed companies representing nine sectors of the main board of Bursa Malaysia from 2009 to 2011. Three corporate governance components used in this study are proportion of non-executive directors (NED), board leadership structure, and board size. Firm performance is measured in terms of firm earnings per share (EPS) and return on equity (ROE). The study discovered the influence of the three corporate governance measurements on both dimensions of firm performance from years 2009 to 2011 are mixed. The influence of corporate governance on the financial performance of Malaysian listed companies similar to previous studies in Malaysia or in other countries. It can be concluded that although various corporate governance reform has been undertaking in Malaysia since year 2000, the reform has not much effect on financial performance.

Keywords: corporate governance, board of directors and firm performance.

Corporate Governance and Firm Performance of Listed Companies in Malaysia

The development in the corporate governance literature expresses concerns about the importance of having good governance of a company. The need for good governance is evidenced by the various reforms and standards developed not only at the country level, but also at an international level (e.g., the Sarbanes-Oxley Act in the US, Combined Code in the UK, and the Organization for Economic Development [OECD] Code). Typically, in the economic and strategic management literature, corporate governance is considered as the institutions to mitigate the effects of agency problem existent in the organizations.

In Malaysia, before the Asian financial crisis in 1997/1998, the importance of having good corporate governance had not received much attention in this country. The Asian financial crisis exposed a number of poor corporate governance practices in Malaysia including absence of independent directors, impartial audit committees, and independent auditors in overseeing and disciplining corporate misbehaviours (Liew, 2006), lack of transparency, financial disclosure and accountability, and poor legal protection of minority investors against expropriation by corporate insiders (Claessens and Djankov, 1999). Furthermore, significant dominance and participation of major shareholders in company management in Malaysia have allowed some of them to act in their own interests, leading to corporate misbehaviours (Khoo, 2003). This has adversely affected the performance of Malaysian PLCs, leading to a number of Malaysian companies having higher leverage and a higher proportion of short-term debts (Claessens et al., 2000) and financial distress (Abdullah, 2006). In effect, a number of corporate collapses occurred, such as Perwaja Steel, Berhad, Renong Berhad, and KFC Holding Berhad, due partly to the lack of effective corporate governance mechanisms (Haniffa and Hudaib, 2006). This implies that poor corporate governance contributed to the financial crisis in Malaysia.

The financial crisis has provided added momentum to corporate governance reforms in Malaysia. In 2000, the Malaysian government took a major initiative by establishing the Malaysian Code of Corporate Governance (MCCG), which identifies a framework for best practices in corporate governance. Since then, the development of Malaysian corporate has progressed on a periodic basis. The success of Malaysian corporate governance reforms was reflected in a survey conducted by PricewaterhouseCooper and the Kuala Lumpur Stock Exchange (KLSE) in 2002. The survey concluded that Malaysian corporate governance standards have been improved since the issue of the MCCG in 2000. In another study, the Malaysian corporate governance score was 77.3%, which is higher than among several other Asian countries¹ and comparable to other developed countries, such as Singapore, Hong Kong, and Australia (McGee, 2008). In fact, it was revealed 78% of institutional investors in Malaysia are in favour of the improvement of existing rules and regulation to further enhance corporate governance in Malaysia, in particular, to act in the interests of shareholders (Gul and Tsui, 2004) and for the growth of capital markets.

Nevertheless, it was argued that the promotion of corporate governance reform in Malaysia has not been providing solutions or targeting specific local problems in the country (Liew, 2006). For example, the Asian Development Bank (2004) reported that, after five years of the promotion of Malaysian corporate governance, there is not much improvement in Malaysian foreign direct investment (FDI)². Arif et al. (2007) asserted that Malaysian firms have started to put extra efforts into their corporate governance and this trend is expected to continue in the near

¹The score was out of 100%. Other countries' scores: India 83.6%, Korea 76.4%, Pakistan 75.5%, Thailand 72.7%, Philippines 64.5%, Indonesia 60%, and Vietnam 50.1% (McGee, 2008).

²In 1997, Malaysian FDI as a percentage of gross domestic product (GDP) was more than 30%, and it decreased over the year after the crisis and was just 7% in 2003 (Asian Development Bank (ADB), 2004).

future. Based on the above arguments, it is hoped that this study can advance the international corporate governance research agenda by examining three corporate governance components (number of independent directors, leadership structure, and board size) and two firm performance measurements (return on equity and earnings per share) within the Malaysian context.

Review of Literature and Hypothesis Development

It is acknowledged that no single characteristics that explain general pattern of links between corporate governance and firm performance. The relationship between corporate governance and firm performance is more “varied and complex” than can be covered by any single governance theory. Hence, various studies discovered a number of corporate governance components have influence firm performance, such as number or percentage of independent directors, board leadership structure, board size, audit committee, board attributes, and board meeting (see Abdullah, 2004; Coskan and Sayiar, 2012; Shukeri et al., 2012) . For the purpose of this paper, only three corporate governance components that found to be the most important determinant of financial performance are reviewed. They are number of independent director on the board; board leadership structure; and board size.

Proportion of Non-Executive Directors

Non-executive directors are known as ‘non-employees’ or outside directors (Mace, 1972). From the agency theory perspective, non-executive directors (NEDs) contribute to effective governance by exercising control over top managers’ decision-making, because they are seen as the check and balance mechanism to enhance board’s effectiveness. NEDs are expected to bring independence into the board and add to the diversity of skills and expertise of the directors (Abdullah, 2004).

Despite the advantages of having more NEDs on the board, prior studies documented mixed results from analyses of the relationship between the proportion of NEDs and firm performance. In Korea, Choi et al. (2007) found a positive effect on the firm performance as a result of having independent directors on the company board. A similar situation was found in Ghana when Abor and Adjasi (2007) revealed that the presence of outside independent directors on boards enhanced corporate competitiveness and provided new strategic outlooks for the firms. Likewise, Awan (2012) also discovered positive relationship between NEDs and firm performance measured by return on assets (ROA) and return on equity (ROE). In contrast, Zong-Jun and Xiao-Lan (2006) revealed that a larger proportion of NEDs is negatively associated with the probability of distress among firms in China. Likewise, Abdullah (2006) concluded from research into financially distressed and non-distressed companies listed on the Bursa Malaysia that non-executive independent directors are not associated with a financially distressed status. It was argued that, the negative impact of NEDs on firm performance was because they are not able to ratify decisions made by powerful board members as they lack company information (Conger and Lawler, 2009). As a consequence, they have some difficulties in understanding of the working of their companies (Siladi, 2006).

Several studies in Malaysia also present contradictory evidence suggesting the advantages and disadvantages of having a high percentage of non-executive directors on boards. A study by Abdullah (2002) involving the KLSE main board listed-companies showed that Malaysian listed companies' boards that were dominated by non-executive independents had positive relationships with the presence of large shareholders, while negatively related to directors' shareholding and CEO duality. Meanwhile, other studies found that a higher percentage of non-executive directors had led to better auditing systems (Salleh et al., 2005), and

improved financial reporting timelines (Abdullah, 2006). However, other studies found that non-executive directors in Malaysia had not influenced the performance of Malaysian firms (Haniffa and Hudaib, 2006; Rahman and Mohamed Ali, 2006). It was argued that in most developing countries, including Malaysia, independent directors were not selected based on their expertise and experience, but more often for political reasons to legitimate business activities and for contacts and contracts (Haniffa and Hudaib, 2006). Due to lack of expertise, lack of required skills and knowledge of company affairs, such directors would not be able to perform their roles effectively (Rahman and Mohamed Ali, 2006). This implies that the performance of Malaysian PLCs does not entirely depend on the presence of non-executives on the boards. Therefore, it is hypothesized that:

Hypothesis 1. There is a relationship between non-executive independent directors (NEDs) and firm performance.

Board Leadership Structure

Agency theory argues for a clear separation of the responsibilities of the CEO and the chairman of the board and seems to prefer to have separate leadership structure. The reason is that, if the CEO and the chairman of the board is the same person, there would be no other individual to monitor his or her actions, and CEO will be very powerful and may maximize his or her own interests at the expense of the shareholders (Coskan and Sayiar, 2012). Thus, a separate leadership structure is recommended in order to monitor the CEO objectively and effectively.

Evidence on the relationship between CEO duality and firm performance are mixed. Some studies provide evidence of a positive relationship between duality of roles and firm performance. Joshua (2007) found significant and positive associations between capital structure

and CEO duality among Ghanaian firms. Likewise, Tin Yan and Shu Kam (2008) found that the duality role is more effective, because one individual can exercise full control over the firm and the person can provide a centralised focus on achieving organisational goals. In the US, Harjoto and Hoje (2008) found a positive relationship between CEO duality and firm values and performance.

On the contrary, Schmid and Zimmermann (2005), from their study of 152 Swiss firms, revealed no evidence of a systematic and significant difference in firm value between firms with a combination or firms with a separation function of chairman/CEO. In Egypt, Elsayed (2007) found that CEO duality had no impact on corporate performance. In Malaysia, many studies show that duality roles have no impact on the performance of Malaysian firms (Rahman and Haniffa, 2005; Abdullah, 2006). Another study found that firms that had duality roles were not performing as well as their counterparts with separate board leadership (Rahman and Haniffa, 2005). In addition, firms dominated by a single person led to financial reports being issued much later than those with separation of roles (Abdullah, 2004). This could be because centralisation of power resulting from the chairman-CEO duality could be detrimental to board effectiveness, since the same person would manage and dominate board decisions. Overall, this review finds that the impact of dual roles on board and firm performance is different from one country to another. Both types of leadership structure are associated with similar effects on the firms and leading to the following hypotheses:

Hypothesis 2. There is a relationship between board leadership structure and firm performance.

Board Size

Board size refers to the number of directors sitting on the board (Levrau and Van den Berghe, 2007). Board size has been found to vary between one country and another. For example, boards in Europe, in three countries (the UK, Switzerland, and the Netherlands) tend to have a small board size (fewer than ten board members), while other countries (e.g., Belgium, France, Spain, Italy, and Germany) had a larger board size, i.e., between thirteen and nineteen members (Heidrick and Struggles, 2007). In Australia, board size has an average of seven members (Korn/Ferry International and Egan Associates, 2007). However, Conger and Lawler (2009) argued that, there is no magical or ideal size for a board and the right size for a board should be driven by how effectively the board can operate as a team.

The impact of board size on board and firm performance has been a matter of continuing debate. Some studies discovered a positive relationship between board size and firm performance. For example, Chen et al. (2006) found board size is positively related to earning per share among listed companies in China. Furthermore, Andres and Vallelado (2008) revealed larger boards are more efficient in monitoring and advising functions and create more value for a firm. More recently, Shukeri et al. (2012) found board size positively influence firm ROA. In contrast, many researchers provide empirical evidence of a negative relationship between board size and firm performance. Beiner et al. (2004) analysed the relationship between board size and the independent corporate governance mechanism of Swiss firms, and revealed a negative board size effect. Van Ees et al. (2008) performed a similar study on listed firms in the Netherlands and found that, even though the system of control mechanisms is different in the Netherlands from in

their US counterparts, there is a negative relationship between board size and firm performance in the Netherlands, similar to the US. In addition, Dey and Chauhan (2009) revealed that, as board size increases, group dynamics, communication gaps, and coordination cost increase.

These mixed results show that the relationship between board size and firm performance is inconclusive. One possible explanation for the conflicting findings regarding the relationship between board size and firm performance is the endogeneity of some factors in the firm performance model. For example, board size itself may be influenced by other governance factors, such as board structure and board leadership (Colley et al., 2005). For these reasons, it can be concluded that there is no consensus about whether larger or smaller boards are better with respect to their impact on firm performance, irrespective of the type of performance indicators used. It is hypothesized that:

Hypothesis 3. There is a relationship between board size and firm performance.

Research Design and Methodology

Research Design and Sample

The main objective of this study is to investigate the relationship between three corporate governance components and firm performance within the Malaysian corporate governance environment. Thus, this study utilized purely quantitative methods. To do so, this study utilizes the Bursa Malaysia databases to generate information from the annual reports of

Malaysian PLCs, based on the FTSE Bursa Malaysia Index³ (as measured by market capitalization) between 2009 to 2011. 813 companies selected for analysis in this study were among the biggest companies in Malaysia; they are also recognisable in terms of their performance. The three years period chosen will also provide additional insight into firm performance, which possibly effects the company's performance during the world economic crisis. The selection of sample used in this study is similar to other corporate governance studies (i.e., Abdullah, 2004; Levrau and Van den Berghe, 2007; and Van Ees et al., 2008).

Measurement Procedures

Corporate Governance. This study use three variable representing corporate governance components, i.e., board size, duality of roles of chairman/CEO, and composition of NEDs, in line with many corporate governance studies (Levrau and Van den Berghe, 2007; Van Ees et al., 2008; and Awan, 2012). First, we calculated the size of each board in the data set; second, we measured CEO duality by classifying chairmen as either an executive chairman (one person in the role of CEO and chairman and coded 1); and third, we classified each director as either an executive (inside) director or a non-executive (outside) director. This allowed us to calculate the percentage of outsiders on each board.

Firm Performance. Although there are many measures of firm performance, this study followed the predominant approach and used two financial measures of firm performance, return

³The FTSE Bursa Malaysia Index is a comprehensive range of real-time indices, which cover all eligible companies listed on the Bursa Malaysia Main Board introduced to Bursa Malaysia's investors in 2006. The indices are to measure the performance of the major capital segments of the Malaysian market. Further information is available on

http://www.ftse.com/Indices/FTSE_Bursa_Malaysia_Index_Series/index.jsp

or http://www.klse.com.my/website/bm/market_information/index_components.html

on equity (ROE) and earnings per share (EPS). Financial measures of firm financial performance fit into accounting-based measures. Examples used in the governance literature include ROA and ROE (Rahman and Haniffa, 2006; Haron et al., 2008; and Awan, 2012). In general, the major concern with accounting measures is that, they are historical and so lag the actual actions that bring about the results. As well as this is a common measure used in the literature. Table 1 summarizes the variables and their measurement used in this study.

Table 1. Operational definition of variables

Variables	Measurement Scale
Board size	Total number of directors on board.
Proportion of independent directors	Ration of independent directors to total number of directors on board.
CEO duality	Indicator variables with the value of “0” if the role of chairman and CEO combines and “1” otherwise.
Earnings per share (EPS)	$\frac{\text{Net income} - \text{Dividends on preferred stock}}{\text{Average outstanding shares}}$
Return on equity (ROE)	$\frac{\text{Profit after tax}}{\text{Shareholders' fund}}$

Data Analysis

The annual reports of the companies that were downloaded from Bursa Malaysia website have been entered into a database. The files then were exported into an SPSS file for further analysis. This study employs descriptive and parametric statistics analysis. Since the hypotheses predict the non-directional of correlation, we employed two-tail significant tests. In order to test

the hypotheses, Spearman's correlation matrix was employed. The Spearman's correlation was used to identify the relationship between corporate governance and firm performance.

Results and Discussions

Relationship between Independent Non-Executive Directors and Firm Performance

The analysis of Spearman's correlation matrix is conducted to find the relationship between independent non-executive directors and firm performance reported to be mixed (Table 2). At significant level 0.05, the relationships were not significant for 2009, 2010, and 2011 for ROE with $r = 0.102, 0.097, \text{ and } 0.102$ ($p = 0.093, 0.110, \text{ and } 0.088 < 0.05$). However, at significant level 0.01, in 2009, 2010, and 2011 independent non-executive directors influenced the EPS with $r = 0.221, 0.259, \text{ and } 0.243$ ($p = 0.000, 0.000, \text{ and } 0.000$). This result confirms with previous study, which revealed inconsistency relationship between independent directors and firm performance (Abor and Adjasi, 2007; Rahman and Mohamed Ali, 2006). The positive effect can be explained because the presence of outside independent directors on boards enhanced corporate competitiveness and provided new strategic outlooks for the firms (Abor and Adjasi, 2007). By emphasizing the potential for divergence of interests between investors and managers, agency theorists predict that where board of directors is more independent of management and enhance auditing system of the companies (Salleh et al., 2005), and finally increased company performance would be higher. On the contrary of no relationship of the two independent and dependent variables can be resulted on the arguments that have limited time to involve in company operation (Conger and Lawler, 2009). As a whole, the result of the relationship between independent non-executive directors and firm performance among Malaysian companies is mixed. Therefore, the Hypothesis 1 is accepted.

Table 2. Relationship between independent non-executive directors and firm performance

Firm performance variable	Corporate governance variable	2009		2010		2011	
		R	Sig.	R	Sig.	R	Sig.
Return on equity	Independent non-executive director	0.102	0.093	0.097	0.110	0.104	0.088
Earnings per share	Independent non-executive director	0.221**	0.000	0.259**	0.000	0.243**	0.000

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

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

Relationship between Leadership Structure and Firm Performance

The results of Spearman's correlation on the relationship between leadership structure and firm performance also found to be mixed (Table 3). However, at significant level 0.01 and 0.05 only in year 2001, the relationships between leadership structure and ROE found to be significant ($p = 0.003 < 0.01$). The result shows that leadership structure has not influence the financial performance of Malaysian firms measured by ROE and ROA, which was similar to previous studies in Malaysia (Rahman and Haniffa, 2005; Abdullah, 2006) as well as in other countries (Elsayed, 2007; Coskan and Syiar, 2012).

Table 3. Relationship between leadership structure and firm performance

Firm performance variable	Corporate governance variable	2009		2010		2011	
		R	Sig.	R	Sig.	R	Sig.
Return on equity	Leadership structure	0.114	0.061	0.075	0.216	0.183**	0.003
Earnings per share	Leadership structure	0.064	0.294	0.013	0.830	0.008	0.894

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

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

The result can be explained because in Malaysia duality roles of CEO and chairman among the listed companies is not common as compared to other developed countries such as the US, United Kingdom, and Australia. The duality roles of chairman and CEO only found to be common for a few family owned firms. Therefore, the duality role of CEO is not a major influence of firm performance of Malaysian companies. Therefore, the hypothesis is rejected.

Relationship between Board Size and Firm Performance

The results of the relationship between board size and firm performance also reported mixed (Table 4). At significant level 0.05, the relationships were significant for 2009 and 2011 for ROE with $r = 0.126$ and 0.171 ($p = 0.038$, $0.005 < 0.05$ and 0.01) and not significance in 2010 with $r = 0.101$ ($p = 0.095 < 0.05$). However, at significant level 0.01, board size significantly influence ROA for years 2009, 2010, and 2011 with $r = 0.242$, 0.223 , and 0.219 ($p = 0.000$, 0.000 , and $0.000 < 0.01$). It was concluded that boards dominated by non-executive director's result a high performance.

Table 4. The relationship between board size and firm performance

Firm performance variable	Corporate governance variable	2009		2010		2011	
		R	Sig.	R	Sig.	R	Sig.
Return on equity	Board size	0.126*	0.038	0.101	0.095	0.171**	0.005
Earnings per share	Board size	0.242**	0.000	0.233**	0.000	0.219**	0.000

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

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

One of the reasons of the positive relationship is based on the argument that as the average board size of Malaysian companies is between 13 to 15, considered the right size (Conger and Lawler, 2009). Moreover, the size found to be efficient size in monitoring, possibly through closely monitored management and advising the board (Adreas and Vallelado, 2008). Hence, the finding support prior studies (Chen et al., 2006; Adreas and Vallelado, 2008; and Shukeri et al., 2012). Then, the Hypothesis 3 is accepted.

Table 5 presents Spearman's correlation for all the variables in the study for years 2009, 2010, and 2011. It examined the association between the corporate governance variables and firm performance variables. Overall, the correlations were low for 2009, 2010, and 2011. But there are a number of statistically significant relationships. Note that, the data does not suggest multicollinearity problems, which usually require correlations between variables of 0.80 or more, which is used as an indicator of serious multicollinearity (Gujarati, 1992).

However, correlation test results did not show any significant correlation between return on equity and independent directors and board size for 2009 and 2010, but return on equity indicate significantly correlated with leadership structure in 2011. However, earning per share for independent non-executive directors and board size for were all significantly correlated in 2009

to 2011, rather earnings per share is not significantly correlated with leadership structure in both the years.

Table 5. Summary of Spearman's correlation matrix for three years 2009-2011

Variables	2009		2010		2011	
	Spearman's correlation	Sig. value	Spearman's correlation	Sig. value	Spearman's correlation	Sig. value
LEAD /ROE	0.114	0.061	0.075	0.216	0.183**	0.003
ID/ROE	0.102	0.093	0.097	0.110	0.104	0.088
BS/ROE	0.126*	0.038	0.101	0.095	0.171**	0.005
LEAD/EPS	0.064	0.294	0.013	0.830	0.008	0.894
ID/EPS	0.221**	0.000	0.259**	0.000	0.243**	0.000
BS/EPS	0.242**	0.000	0.233**	0.000	0.219**	0.000

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

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

Conclusion

This paper reports and discusses the relationship between corporate governance and firm performance. Three hypotheses were developed and tested each variable to identify the influence of each of the corporate governance variables (non-executive directors, board size, and leadership structure) in relation to two performance indicators (ROE and EPS). From the sample of 813 Malaysian listed companies for the years 2009-2011, the results report that corporate governance components in particular number of independent directors on the board and board size are the essential elements that influence firm performance. Many companies' failures due to the board's incapability to address the overall company performance in an effective and reliable

manner. The main goal for this lies in the structure of the board, particularly in relation to the structure of the decision making process, which needs to be transformed to enable companies to focus on sustaining high performance in the face of a rapidly changing environment. This study stated significant relationships between corporate governance practices of non-executive directors and board size, and firm performance. The growth in the economy, despite the hostile economic conditions, is relatively due to good governance practices adopted by Malaysian companies.

The survival of any corporate sector is to maintain a healthy bottom line amid the economic and political adversities were extremely important to any economy. Organizations were undertaking strategies to curtail risks by diversification into new products and new markets, and undertaking spare reconsiderations of the short-term goals in the setting of a worsening country scenario. Most high performing companies have ventured into new businesses and to offshore destinations. One of the factors for the high performance of companies that operate in this highly unstable environment is their diversification and adopting good corporate governance. Therefore, results show that investors consider good governance practices are important in their investment decisions. This implies importance of good corporate governance in influencing firm performance. The findings also backing for the hypotheses connecting board characteristic variables and firm performance. Good corporate governance was found to moderate many relationships between board characteristics and firm performance. It was discovered that no single theory offers a complete explanation of board characteristics-firm performance relationship, but rather elements of each theory can be seen to apply in different circumstances.

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