Can good corporate governance practices contribute to firms’ financial performance? – evidence from Malaysian companies

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Abstract: This paper examines the impact of corporate governance practices and structures on the performance of firms in Malaysia. An empirical study was conducted based on data involving 120 Malaysian-listed companies over a four-year period from 1996 to 1999. This period encompassed the 1997/98 Asian financial crisis, which affected most countries in the Southeast Asian region including Malaysia. Due to the combination of cross-sectional and time-series data, panel data regression techniques were used to analyse performance of the firms using both fixed effects and random effects models. Using Return on Equity (ROE) as the dependent variable, it was established that the size of firm, gearing ratio (borrowing) and dominant CEOs (Chief Executive Officers) significantly influenced the performance of firms. The impact of size on the performance of firms followed a quadratic fashion with performance increasing with the size of the firm up to the optimal size of around 7,729 million Malaysian Ringgit (RM). Beyond that, firm performance declined with increasing size. Borrowing had a negative effect on earnings with 1% increase in borrowing having a 0.13% decrease in ROE. Finally, CEOs who are also chairman of the board exert a positive influence on company earnings. The study suggests that dominant CEOs could increase performance of firms when they dominate the decision-making process in their companies.

Keywords: corporate governance; board practices; board structure; firm performance.


Biographical notes: Allan Chang Aik Leng has an MA in Accounting and Finance (Lancaster), FCCA (UK), ACMA (UK), is a Lecturer in accounting and finance at University of Brunei Darussalam. He has just submitted his PhD thesis and this article is a brief summary of the findings of the four-year study. He has been a lecturer for 17 years and was formerly a lecturer at University Technology MARA, where he lectured for 12 years. Mr. Chang is a qualified chartered certified accountant and had been working in the private sector for six years prior to joining the university as an academician.

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1 Introduction

Poor governance standards in both corporate entities and government were blamed in part for the East Asian financial crisis. In Asia, corporations tend to follow the ‘insider’ model with dominant control by owners and large shareholders (Sycip, 1998; Yamazawa, 1998). The erosion of investor confidence was identified as one of the major factors that exacerbated the financial turmoil in Malaysia and a number of Asian countries. Many commentators, for example, Noordin (1999) argued that the erosion of investor confidence in Malaysia was brought about by the country’s poor corporate governance standards and lack of transparency in the financial system. The restoration of full confidence in the economy by investors would rely on the improvement of corporate governance standards including the adoption of transparency as an important strategy in corporate management. The paper focuses on the corporate practices of Malaysian companies and attempts to measure its impact on firm performance. Certain corporate structures and practices are examined to determine if they have any effect on company’s performance, and these are:

- the role of lenders in corporate governance
- the governance role of independent directors
- the CEO duality structure
- the governance role of institutional investors
- the concentrated ownership structure
- the governance role of audit committees.

2 Literature review

2.1 The role of lenders in corporate governance

The role of lenders as a force in corporate governance has not yet been extensively analysed (Prigge, 1998). Lenders are interested in the repayment of credit in accordance with the credit contract. Since management’s actions are one of the factors determining repayment, lenders may be motivated to carry out monitoring. Bilimoria (1997) found evidence to indicate that Chief Executive Officers (CEOs) of highly leveraged firms were
paid less long-term pay. Using three criteria (total voting power at the general meeting, chairmanship on the supervisory board, and liabilities owed to banks [data from 1990–1992]), Perlitz and Seger (1994) divide a sample of 110 listed industry companies into one group of which banks have a great potential influence (58 companies) and one group of which banks only have a small potential influence (52 companies). They found a significant difference between both categories: companies of the first group show a significantly lower profitability and growth. Similarly, Cable (1985) and Nibler (1995) discover a positive relation. Cable (1985) finds a positive relation between bankers’ supervisory board membership and company performance. On the other hand, Chirinko and Elston (1996), using the same criterion for potential bank influence, do not find a relation. However, they find a highly significant substitution relation between ownership concentration and bank influence, suggesting that banks fill the control gap at companies with dispersed ownership.

2.2 The governance role of independent directors

Byrnan and Hickman (1992) report that tender offer bidders with majority-independent boards earn roughly zero stock price returns on average, while bidders without such boards suffer statistically significant losses of 1.8% on average. You et al. (1986) also report a significant negative correlation between proportion of inside directors and bidder stock price returns. This suggests that independent directors may help restrain the tendencies of CEOs to build larger empires, even if this means overpaying to buy another company. Denis and Sarin (1997) report that firms that substantially increased the proportion of independent directors had above-average stock price returns in the previous year. In a study to assess investor reaction to the appointment of additional directors, Rosenstein and Wyatt (1990) found that stock prices increase by about 0.2% on average, when companies appoint additional outside directors. This increase was statistically significant, but economically small.

2.3 The CEO duality structure

Rechner and Dalton (1991) examined the relation between CEO duality and organisational performance. Their study supports agency theory expectations about inferior shareholder returns from CEO duality. Rechner and Dalton (1989) also examined the effect of CEO duality on risk-adjusted shareholder returns using stock market data for the same sample and period. They found no significant difference between structures. Donaldson and Davis (1991) examined the effects of CEO duality on shareholder returns, and recorded exactly the opposite result to that of Rechner and Dalton (1991). Their results show that the average ROE of the board with chairs independent of the CEO was 11.5%, less than the average ROE of those companies with CEO duality at 14.8%. The difference was statistically significant, i.e., dual CEO structures outperform independent chair structures.
2.4 The governance role of institutional investors

Large outside (institutional) shareholders are regarded as an effective monitoring mechanism for a number of reasons. For example, they have a vested interest in minimising any asymmetry of information which may exist and will therefore vote in accordance with their own interests (Jarrell and Poulson, 1987). In addition to the monitoring role, Shleifer and Vishny (1986) also argue that large outside shareholders assist the market for corporate control simply by being willing to sell their shares should an appropriate bid be made. They, therefore, have an incentive to monitor the behaviour of managers, which should solve the free-rider problem identified by Grossman and Hart (1980).

2.5 The concentrated ownership structure

As regards the relationship between ownership concentration and firm performance, empirical results in the USA are inconclusive. Demsetz and Lehn (1985) found no significant correlation between ownership concentration and profit rates for 511 large corporations. Morck et al. (1988) reported a piecewise linear relationship of Tobin’s Q with board member ownership for 371 Fortune 500 firms, and also found evidence of an inverted U-shaped relationship between the degree of ownership concentration and profitability. Stulz (1988) demonstrates that higher managerial ownership can insulate managers from external takeovers, and by allowing managers to block takeover bids, can lower firm value. Using US data, Morck et al. (1988), McConnell and Servaes (1990; 1995), Hermalin and Weisbach (1991), and Holderness et al. (1999) all find firm value to rise with low levels of managerial ownership and to fall with higher levels of managerial ownership.

2.6 The governance role of audit committees

Several empirical studies in accounting have focused on the voluntary formation of audit committees to identify factors affecting an entity’s decision to create an audit committee directly responsible for overseeing the financial reporting process (Pincus et al., 1989). Collectively, these studies suggest that larger companies, who are audited by the Big five and who have bigger boards with greater representation of outside directors, are among the companies more likely to voluntarily form an audit committee. Several studies document that the presence of an audit committee is associated with fewer incidences of financial reporting problems. For example, McMullen (1996) finds that entities with more reliable financial reporting, such as those with absence of material errors, irregularities and illegal acts, are significantly more likely to have audit committees. DeChow et al. (1996) show that firms subject to Securities Exchange Commission, USA (SEC) enforcement actions are less likely to have standing audit committees. More recent descriptive research shows that 25% of the companies subject to SEC enforcement actions do not have audit committees in place (COSO, 1999). Carcello and Neal (1999) find that the likelihood a company in financial distress will receive a going concern modified auditor’s report is lower when the percentage of inside or grey directors on the audit committee is higher.
3 Methods and procedures

Data were gathered on 120 Malaysian publicly listed companies during the period 1996 to 1999. The samples were public companies fully quoted either on the main board or the second board of the Kuala Lumpur Stock Exchange (KLSE). A large majority of the companies selected (87%) comes from the main board. The samples covered all sectors of the economy. The samples were drawn from 20 volumes of KLSE Annual Companies handbook on a random basis until the required quota was reached. The sample selected is in line with other previous research on this area, e.g., Yeboah-Duah (1993) studied a sample of 210 Malaysian firms for the period 1984–1991, Mat-Nor et al. (1999) used 79 Malaysian firms, Ruhani and Sandra (2001) used 112 KLSE-listed firms covering the period 1992–1997, and Yap (2001) used 69 KLSE companies covering the period 1995–1999.

3.1 Dependent variable

This research utilises the commonly used accounting measure of performance of Public Listed Companies (PLCs) as the dependent variable, namely ROE. ROE is defined as earnings divided by total ordinary shareholders’ fund. These figures were also obtained from the KLSE handbook. The dependent variable is employed as proxy for firm performance. A high score for the variable signifies favourable financial performance.

3.2 Independent variables

The independent variables are factors that influence firm performance, and they affect the ROE by driving them up or down. Seven independent variables were selected. They are represented by:

1. NED – measures the proportion of non-executive directors on the board of directors, expressed as a percentage. It is defined as the number of non-executive directors divided by the total number of directors on the board of the company. The coefficient’s expected sign is positive, i.e., the higher the proportion, the more independent is the board in making decisions. This implies better company performance, measured by the dividend payout and ROE ratio.

2. CHAIRAC – a binary variable. If the chairman of the audit committee is a non-executive director, it is coded ‘1’, otherwise ‘0’. This serves to test the degree of independence of the audit committee. An independent chairman is expected to contribute to a more rigorous regime of monitoring and therefore improves performance of the company.

3. CEOCHAR – a binary variable. If the positions of the CEO and the chairman of the board are filled by a single person, the variable has the value of ‘1’, and ‘0’ if they are not. The coefficient’s expected sign is negative. This is because the effectiveness of the board as an internal governance devise will be perceived to have been compromised by the roles not being separated. On the other hand, a unity of command structure can motivate the CEO to strive for excellent performance. If this is the case, the coefficient’s sign is expected to be positive.
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4 INST – measures the proportion of large institutional investors. The higher the proportion, the greater is the monitoring role of institutional investors. It also implies that managers of companies would be under pressure to perform to the expectations of institutional investors. The coefficient is expected to be positive.

5 GEAR – measures the proportion of large borrowings. It is a gearing ratio and is defined as long-term borrowings/debt divided by the total shareholders ordinary fund plus long-term debt. The coefficient is expected to be positive since greater borrowings imply that lenders/banks will be expected to play a greater monitoring role.

6 CONCEN – measures the proportion of concentrated ownership. The higher the proportion, the greater is the monitoring role of large owners. This is in line with agency theory which hypothesised that greater ownership would reduce agency costs and hence improve performance. The coefficient is expected to be positive.

7 SIZE – captures the size of the company in terms of turnover. Size is expected to be a positive influence on company performance due to greater diversification, the economy of large-scale production and greater access to new technology and cheaper sources of funds. The coefficient is expected to be positive.

3.2.1 Monitoring measures

Six measures of monitoring were used in this study. These are divided into two types: internal or external monitoring measures:

1 Internal monitoring measures

The first internal monitoring measure is the ratio of the number of outside (non-executive) directors to total directors (i.e., inside and outside directors), a measure commonly used by researchers to measure corporate control (e.g., Morck et al., 1988; Weisbach, 1988; Beatty and Zajac, 1994). The second internal monitoring measure is the dichotomous CEO/chairman variable, indicating whether the CEO position is separated from the chairman of the board. The third internal monitoring measure is the presence of an independent audit committee who can be expected to monitor firm performance and give advice. The fourth monitoring measure is the presence of concentrated ownership, which by virtue of their large shareholdings will increase their monitoring as their proportion of share capital increases.

2 External monitoring measures

The first external monitoring measure is the presence of large creditors, i.e., bank debt. Banks are expected to use their influence as lenders to monitor management to ensure repayment of their principal and interest in the future. The second monitoring measure is the presence of a shareholder with large equity holdings (greater than 5%) who is not on the board (i.e., a blockholder or institutional investors).
H1: Ceteris paribus, a firm’s financial performance will be positively related to sound internal corporate governance structures, i.e., internal monitoring measures.

H2: Ceteris paribus, a firm’s financial performance will be positively related to monitoring by external stakeholders, i.e., external monitoring measures.

3.2.2 Model specification

Most of the literature uses univariate and multivariate logistic regression analysis, or multiple linear regressions to test the firm’s value and ownership (Weir, 1997). The method used in this analysis is the pooled ordinary least squares (OLS), applying the cross-sectional time series standard multiple regressions. The econometric model being formulated is based on ROE as the dependent variable. H1 and H2 are tested using the following OLS model. The model is formulated as follows:

\[ ROE_t = a + bNED_{t-1} + cCHAIRAC_{t-1} + dCEOCHAR_{t-1} + eINST_{t-1} + fGEAR_{t-1} + gCONCEN_{t-1} + h\log\text{SIZE}_{t-1}. \]

where:

- ROE = Return on Equity ratio
- NED = Non-Executive Directors
- CHAIRAC = Chairman of the Audit Committee
- CEOCHAR = Chief Executive Officer and Chairman of the Board
- INST = Institutional investors
- GEAR = Gearing ratio
- CONCEN = Concentrated Ownership
- LogSIZE = Logarithm of Size of Firm

3.2.3 Panel data regression analysis

The OLS regression that was done earlier produced relatively low R² value and low Durbin-Watson statistics. An examination of the F-test and its P-value clearly indicated that the OLS method was not appropriate (Leamer, 1978). This is because the data under study is panel data or sometimes referred as pooled data and consists of a combination of time series and cross-sectional data. Such data requires the use of panel data regression models in order to obtain meaningful results. There are two most frequently used estimation techniques to address these problems, namely the Fixed Effects Model (FEM) and the random effects model (REM) (Gujarati, 2003).

The data collected were for the period 1996–1999 (four years) and involved 120 companies. The data were analysed by the econometric software, Time Series Processor (TSP) version 4.5. Only the dependent variable is expressed in natural logarithm form. Also, another variable was added, namely size-square (sizesq) to test the possibility of a quadratic/curvilinear relationship involving the size of a company.
4 Results

The test results showed that for both models, the hypothesis that there was a single set of slope of coefficients and one overall intercept, was rejected (based on the F-test, Leamer, 1978). The F-test analysis involved a separate regression for each individual company. F-tests for equality within the TOTAL and WITHIN estimators were derived. In addition, the low value of $R^2$ and judging from the Durbin-Watson statistic for testing that P-value equals zero, there is some possibility that a first-order serial correlation of the disturbances will occur. Subsequently, estimation techniques involving the fixed effects and random effects models were used. The results obtained from using these techniques were obviously better, judged by the statistical significance of the estimated coefficients and the high value of $R^2$. The Hausman specification test confirmed the superiority of the fixed effect models over the random effect models. Hence, further interpretative work and discussions only involve the fixed effects model. The results are summarised in Table 1. Using Logged Return on Equity (LROE) as the dependent variable, three significant variables were obtained at the 10% significance level. The estimated value of the $R^2$ was 0.688, which implies that about 69% of the variation in (logged) earnings could be explained jointly by the seven independent variables. The LM heteroscedasticity test (0.998) indicated the absence of significant heteroscedasticity. Also the F-statistic (3.88) is significant at the 1% level. Thus, overall, the model is fairly strong since the $R^2$ value, the explanatory power of the model was quite high.

Table 1  Results of the Fixed Effects Model (FEM) regression analysis using the natural Logarithm of Return on Equity (LROE) as the dependent variable

<table>
<thead>
<tr>
<th>Independent variable</th>
<th>Coefficient</th>
<th>T-statistic</th>
<th>P-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>NED</td>
<td>-0.0003</td>
<td>-0.058</td>
<td>0.954</td>
</tr>
<tr>
<td>CONCEN</td>
<td>-0.016</td>
<td>-1.300</td>
<td>0.195</td>
</tr>
<tr>
<td>SIZE</td>
<td>0.00051</td>
<td>1.503</td>
<td>0.134</td>
</tr>
<tr>
<td>SIZESQUARED</td>
<td>-0.000000033</td>
<td>-1.934</td>
<td>0.054*</td>
</tr>
<tr>
<td>INST</td>
<td>0.013</td>
<td>1.070</td>
<td>0.286</td>
</tr>
<tr>
<td>GEAR</td>
<td>-0.657</td>
<td>-4.358</td>
<td>0.000***</td>
</tr>
<tr>
<td>CHAIRAC</td>
<td>-0.236</td>
<td>-0.617</td>
<td>0.538</td>
</tr>
<tr>
<td>CEOCHAR</td>
<td>0.521</td>
<td>2.185</td>
<td>0.030**</td>
</tr>
</tbody>
</table>

$R^2$ 0.688*

Adjusted $R^2$ 0.518*

Probability level of significance of the LM heteroscedasticity test 0.998

Probability level of significance that the fixed effect model is not superior to the corresponding random effect model based on the Hausman specification test (null hypothesis) 0.002*

Durbin-Watson statistic 1.912

Notes:  
* Denotes statistically significant variables at 10% level  
** Denotes statistically significant variables at 5% level  
*** Denotes statistically significant variables at 1% level
The three statistically significant variables are SIZESQUARED, GEAR and CEOCHAR. Assuming all other things constant, the optimum size of a company at which ROEs are maximised is RM7,727 million, based on turnover.

The significant findings relate to the following three independent variables:

1 **CEOCHAR**
   
The estimated coefficient for this variable is 0.52. This is statistically significant at 5% level, and can be interpreted as: everything else constant, companies that have a dominant personality (who holds the dual positions of CEO and chairman of the board of directors), can improve ROE by 68.37% or \((e^{0.52} - 1)\) compared to companies that do not combine the two positions. The results indicate that a dominant CEO acting also as the chairman of the board has significant influence over company earnings. Since the CEO dominates decisions made in the company, he/she is expected to work hard to improve earnings.

2 **GEAR**
   
The resulting coefficient is \(-0.657\). The parameter estimate is highly significant (at 0.000 level). It can be interpreted as: 1% increase in gearing leads to a 0.13% \((0.657 \times 0.20)\) decrease in ROE, given that the mean GEAR is 0.20. For a log-lin (semi-logarithmic) function, the elasticity is the coefficient estimate multiplied by the value of the independent variable. In this study, the mean value of GEAR is used.

3 **SIZE**
   
The results show that company size in terms of turnover does influence earnings. However, the relationship is rather complex as it indicated a parabola shaped curve of size over earnings. This is interpreted as: the larger the company, the better the earnings, but when the company gets too large, earnings begin to suffer. By using algebraic differentiation, it was found that earnings are maximised at the turnover level of RM7,727 million or about 58% of the maximum (turnover) size of RM13,294 million.

5 **Conclusion and policy implications**

There were major significant findings in this study. Out of the seven independent variables that were hypothesised to influence ROE, three were found to have a significant impact on ROE. This finding has some policy implications. The three independent variables which were found to be significant are:

1 the dominant role of the CEO and chairman of the board
2 gearing (borrowing)
3 size of company.

The results of the latter two variables are expected and are in accordance with the accounting and finance literature. These two variables (gear and size) can actually be termed control variables in this study as the findings are not related to corporate
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governance structures, which are the subject of this thesis. The results relating to gearing (borrowing) can be explained as follows: an increase in borrowing burdens the companies with interest payments which are directly charged to the income statement, thus dampening profits. This explains the negative sign for the resulting coefficient. However, according to the literature on corporate governance, high borrowing encourages the banks and creditors to monitor the company and therefore is expected to contribute to higher profits through investments in value-enhancing projects. The results obtained clearly indicate that this is not the case in Malaysia. Banks do not perform such a value-enhancing role.

The second significant result relating to size is the latest contribution to the Malaysian corporate literature because this is one of the first few studies to prove that size has been positively identified with earnings. Furthermore, the study identified that the graphical function of size against earnings as a parabola-shape, with an optimum turnover of RM7,727 million. The study thus proves that even though size matters when it comes to earnings, there is a limit, and a corporation which has become too large can suffer reduced earnings. This can be explained in terms of managers favouring empire-building at the expense of the productivity of the company. It can also indicate the CEOs inability to exert control and his/her lack of technical expertise to run large enterprises. The current corporate trend in the USA and Europe is to focus on a company’s core business and get rid of unrelated businesses of which top managers know very little. The study provides evidence that Malaysian companies may have to follow such an example.

The third significant variable (CEOCHAR) is the only one that relates corporate governance structures to firm performance. The existence of a dominant personality where the CEO is also the chairman of the board may have some bearing on company performance in Malaysia. The debate in the UK to separate the roles of the CEO from the chairman of the board seems to be inapplicable to Malaysian firms. The results show that dominant CEOs could improve firm performance. It seems that when CEOs dominate the decision-making process in the company, they tend to work hard to improve firm performance. However, this does not mean that such a corporate structure encourages better governance. It could be the opposite. There are numerous examples of dominant CEOs (e.g., BCCI and Maxwell Group of UK) that points to cheating on a massive scale. This topic remains controversial and the problem is not just confined to Malaysia. Numerous other studies indicate mixed results. However, dominant CEOs are a common phenomenon in a developing economy and the results of this study indicate that this could bring positive outcomes. A strong dominant CEO may be essential for a developing economy where the system may be dependent on a few powerful corporate players to push for performance in these companies. In a more mature economy, a dominant CEO may be less important.

In this study, it was found that institutional investors do not exert any influence on firm performance. This finding was expected as institutional investors in Malaysia are not generally known to be actively involved in shareholder activism in the companies they had invested in. The results indicate that institutional investors are not actively exerting their influence through their voting power. Most have short-term objectives. Its influence rests in its ability to exit en masse and such actions could result in a fall in share prices. It seems that the role of institutional investors may be limited to monitoring without intervention.
Contrary to some written literature, it is found that non-executive directors in Malaysia have no influence on ROE, i.e., profitability of the company. It seems that these non-executive directors are not really independent enough to play a serious monitoring role, and the results seem to indicate that they may not be of high calibre to contribute significantly to firm performance. The results also indicate that even if the non-executive directors are a majority on the board, they have not significantly influenced ROE, signifying the lack of independence, which is expected of them.

The results have shown that audit committee chairmen who are non-executive directors in these companies do not play a significant role in influencing ROE. The fact that the chairman of the audit committee is a non-executive director has no bearing on performance. The same is also true even if the majority of the committee members are non-executive directors. The results are similar to the findings of Shamsher and Zulkarnain (2001) who investigate the wealth effect of announcements of audit committee formation by main board firms in the KLSE. This can be explained in terms of the committee’s lack of independence and skill required from the members.

Concentrated ownership in these companies has no bearing on company performance and the argument that large blockholders align their interest with the company appears not to be true in Malaysia. This finding is similar to the results obtained by Faizah (2002) who investigates a similar relationship on plantation companies listed in the KLSE. According to the agency theory, large blockholders solve the agency problems partially and reduce costs. However, since they have control rights, they may be in a better position to expropriate company assets and exploit the interest of the minority. Therefore, the owner-managers may have worked hard to increase earnings but these earnings maybe used to enrich themselves, resulting in the company’s performance remaining unchanged.

References


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