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Research paper

A study of the impact of Malaysian code on corporate governance practices on firm performance in Malaysia

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Abstract

A good corporate governance framework is imperative to improve the corporate governance standards and to establish the roles and responsibilities of the key members of the company. Therefore, considering the importance role of the corporate governance, the aims of this study is to examine the relationship between corporate governance and firm performance by taking into consideration the changes in Malaysia Code on Corporate Governance 2007 (MCCG 2007) and Malaysia Code on Corporate Governance 2012 (MCCG 2012). The sample of this study consists of top 90 firms listed in Bursa Malaysia for the period from 2008 to 2016. The findings indicate that the board independence, board size and board compensation positively and significantly influence the firm performance. On the other hand, CEO duality has a negative impact on firm performance. Thus, the findings of this study shed the light on the significance of practicing good corporate governance to enhance the firm performance.

Keywords: *Corporate Governance; Firm Performance; MCCG.*

1. Introduction

Recently, many countries have started the enforcement on the firms to comply with the code on corporate governance as part of the requirement for the firm to be listed in the market. Over the years, corporate governance has become an important element to prevent from the corporate scandals and most importantly to enhance the reputation of the firms to attract more investors. Many literatures have documented the severe corporate and financial scandals involving well known corporations such as Enron, Parmalat, Xerox, Worldcom, Tyco, Adelphia and HealthSouth (Edwards, 2004) and also one of the big five audit firms, Arthur Anderson. The impact of the high-profile corporate scandals has become the starting point for the policy makers to realise that the poor corporate governance has led to the failure in financial reporting and therefore need to be improved and restructured (A.Arora & Sharma, 2016).

Today, the scale of trade and the complexity of corporations in running the business has increased significantly due to the globalization. The shareholders and the public expect the firms to conduct the business ethically and the dIrectors and key management must pose high integrity in carrying out their responsibilities. Norwani et al., (2011) supported that the integrity of the person involved in the financial reporting is very important in ensuring the reported information is true, transparent and free from any manipulation and fraud as the investors rely on it in decision making process.

In Malaysia, the adoption of Malaysian Code on Corporate Governance has been widely practiced by all the public listed firms as it is part of the listing requirement in Bursa Malaysia. However, the effectiveness of the recommendations in the MCCG toward the value of the firms need to be explored and examined. Since the first introduction of MCCG in 2000, the Security Commission Malaysia (SC) has revised the MCCG in 2007 and 2012. Recently, SC has released the proposed Malaysia Code on Corporate Governance 2016 (MCCG 2016) that emphasizes on the core that companies should aspire to achive. Therefore, the purpose of this study is to examine whether the changes in MCCG 2007 and MCCG 2012 give impact on firm performance.

The rest of this paper is organized as follows: Section 2 presents a review of the relevant literature; Section 3 describes the sample and methodology used in this study; Section 4 discusses the empiral results and Section 5 presents the conclusion and limitations.

2. Literature review

2.1. Board independence

Board independence is the capability of the board to make their decisions without the intervention from insiders in the firm and also to display high professionalism in the decision making process. Nguyen, Locke and Reddy (2014), argued that a firm is said to perform better when board independence is practiced as it gives positive impact on better monitoring and control in the firm. Balsmeier et al., (2014) supported that independent directors with an appropriate professional background can provide valuable knowledge and expertise to the firm. On the other hand, Sukumaran (2013) found negative relationship of board independence in Indian stock market. In addition, Bhuiyan (2015) evidenced that by appointing more independent directors, it could lead to poor firm performance as the directors cannot devote sufficient time to monitor as they need to serve many boards. Nevertheless, Alshetwi (2017) and Bhagat & Black (2000) found there is no relationship between board independence and firm performance.

From the above discussion, there have been a different views on the relationship between board independence and firm performance. Thus, the following hypothesis is developed:
H1. Board independence is positively associated with firm performance.

2.2. Board size

Board size is considered as crucial in board characteristic as the directors need to work together in a group of a certain size to be more efficient and effective. In the past literature, the issue regarding the board size can be viewed from two perspectives. Some supported that larger board size is better than smaller board size because more perspectives can be presented while some argued that smaller board size is more effective to oversight the management. The ideal board size is vary according to the size and complexity of the issues faced by firm. For instance, D. Vo & T.Phan (2013) documented that the ideal board size is 5 while S.M. Zabri et al., (2016) suggested that the ideal is 9. According to D. Vo & T.Phan (2013), ROA has negative impact on board size, thus support that small board size leads to better firm performance in Vietnam. Duppati et al. (2017) evidenced that ROA and Tobin's Q have negative impact on board size.. Alternatively, Mohd Nor et al. (2014) and S.Kumar (2016) argued that larger board size leads to high firm performance as more fresh ideas and skills can be contributed, thus would make them work more efficiently in managing business activities. In line with the above arguments, this study proposes the following hypothesis:
H2. Board size is positively associated with firm performance.

2.3. CEO duality

The concept of CEO duality refers to the position of CEO and chairperson of the board are held simultaneously by one individual (Wijethilake et al., 2015). One of the recommendation in MCCG is to separate the role of CEO and the chairman of the firm. Ilham Nas et al. (2016) found in their study that when the chairman and CEO positions are held by the same individual, it will lead to better firm performance. In contrast, Duru et al.(2016) and Shrivastav & Kalsie (2016) found significant negative impacts between CEO duality and performance which propose that it is vital to separate the CEO and the chairman of the board to provide more clarity in the leadership and direction of the firm. Consequently, CEO might not perform in the best interest of shareholders and the independence of the board might be compromised. Based on the above arguments, this study suggests the following hypothesis:
H3. CEO duality is negatively associated with firm performance.

2.4. Board compensation

Good corporate governance practices should restrain unnecessary payments made to board and compensation should be mainly determined by the firm's performance. Brick et al.(2006) exposed that excessive compensation indicates of poor governance. Lee & Isa (2015), found positive connection between board compensation and firm performance as represented by ROA and ROE in their study which suggested that firms need to offer attractive compensation packages as incentives to attract high talented directors who are able to increase firm performance. Theeravanich (2013) further supported that executive pay is primarily driven by corporate performance which suggests that the higher the board compensation, the higher the firm performance. On the contrary, Zalewska (2014) revealed that there is a negative compensation dispersion with performance in which, the greater the dispersion, the worse the firm performance. Whereas, Nahar Abdullah (2006) claimed that ROA is not found to be associated with board compensation. In the context of this study, board compensation are expected to be positively related to firm performance in order to motivate board of directors to maximize shareholders wealth which led to the following hypothesis:

H4. Board compensation is positively associated with firm performance.

3. Data and methodology

3.1. Data and sample

The sample is constructed based on top 90 companies listed in Bursa Malaysia as on 31/12/2016 and chosen based on market capitalization to be consistent with other studies (R. Pandey et al, 2015). The data are collected over the period 2008 to 2016 to represent the revised Malaysian Code on Corporate Governance in 2007 and 2012. The financial data is obtained from the Thomson Reuters Datasream database while corporate governance attributes are collected from annual reports downloaded from Bursa Malaysia.
The initial sample consists of 90 companies which constitute a total of 720 firms. To be consistent with other studies, the financial firms such as financial institutions, banks, unit trusts and insurance firms are excluded due to their difference in the regulatory requirement and standard (S.Akbar et al, 2016 & R. Pandey et al, 2015). To facilitate the comparison of the results, the financial data was not available during the period are eliminated from the sample. As a result, over the eight years sample period, the final sample constituted 547 firm-year observations.

3.2. Empirical model

In order to examine the relationship between corporate governance and firm performance, the following model is employed:

$$FP = \beta o + \beta 1BIND + \beta 2BSIZE + \beta 3DUOLITY + \beta 4BREM + \beta 5SIZE + \beta 6LEV + \beta 7PROFIT + e \quad (1)$$

Where, FP stands for firm performance. In general, firm performance can be measured by either using financial, operational and market performance (ROE, ROA & Tobin's Q). In the context of this study, all the performance mesures are used to capture different dimensions of performance. Return on Equity (ROE) is measured as earning before interest and tax divided by total equity (A.Arora & Sharma, 2016 & S.M. Zabri et al., (2016) while Return on Asset (ROA) is calculated by earning before interest and tax divided by total asset (R. Pandey et al, 2015 & Shafie Mohamed Zabri et al., 2016). To be consistent with the previous studies, Tobin's Q is measured as the natural logarithm of book value asset less book value of equity plus market value of equity divided by book value of total assets (A.A-N Abdallah & A.K. Ismail, 2017).
Board independence is measured as percentage of independent directors on the board (Buallay et al., 2017). Board size is measured as the number of directors on the board (Kumar, 2016). Next is CEO duality which take a value of 1 if the CEO is also the chairman and a zero value if CEO and the chairman is not the same person (Buallay et al., 2017). Lastly is board remuneration which is measured as natural logarithm of total directors remunerations (Raithatha & Komera, 2016).

Table 1: Description of Variables and Mesurements

Dependent Variables	Measurements
Tobin's Q	Natural logarithm of book value asset less book value of equity plus market value of equity divided by book value of total assets.
Return on Equity (ROE)	EBIT divided by total equity.
Return on Asset (ROA)	EBIT divided by total asset

Independent Variables	Measurements
Board Independence	Percentage of independent directors on the

(BIND)	board.
Board size (BSIZE)	The number of directors on the board.
CEO Duality (DUALITY)	1 = CEO is also chairman 0 = CEO is not chairman
Board Compensation (BCOMP)	Natural logarithm of total directors compensation.
Control Variables	Measurements
Firm Size (SIZE)	Natural logarithm of the firm total assets
Leverage (LEV)	Total debt divided by total asset
Profitability (PROFIT)	Earning Per Share (EPS)

4. Result and discussion

4.1. Descriptive analysis

Table 2: Descriptive Analysis

Variables	Min	Max	Mean	N
Tobin's Q	0.12	0.60	0.16	547
ROE	0.16	35.37	12.64	547
ROA	0.02	0.26	0.09	547
BIND	2.00	9.00	4.01	547
BSIZE	5.00	15.00	8.95	547
DUALITY	0.00	1.00	0.07	547
BCOMP	0.01	8.98	1.18	547
SIZE	4.76	8.12	6.82	547
LEV	0.02	0.97	0.43	547
PROFIT	0.00	1.86	0.31	547

Table 2 presents the summary of the descriptive statistics for the variables used in this study. According to Tobin's Q mesurement, the minimum and maximum are within 0.12 and 0.60. In terms of ROE and ROA, the means are 12.64 and 0.09 respectively. The average independent directors in the sample is four which is consistent with the recommendation in the MCCG. The mean of board size is nine which imply that firm in Malaysia has larger board size. As for CEO duality, the average is 0.07 which specify that only 7% of the firms are held by the same individuals for the positions of CEO and chairman. The average board compensation received is only 1.18 which is relatively lower as compared to the maximum amount of 8.98. In this study, VIF value in terms of the relationship between the independent variables is less than 0.50. For that reason, no violation of multicollinearity was found in this study.

4.2. Regression analyses

Table 3 below present the findings of multiple regression analysis of corporate governance attributes and firm performance where the Tobin's Q, ROE and ROA serve as dependent variables. The adjusted R^2 of regression using Tobin's Q is 40.7%, F-value is 51.05 and p-value of 0.000 which highly significant at 1% level. Furthermore, the adjusted R^2 of model using ROE is 33.30% while ROA is 37.20%. Overall, the adjusted R^2 indicates that the firm performance can be explained by the overall explanatory variables in this study.

Concerning the board independence, the result demonstrates a positive and significant at 1% level using Tobin's Q while another two models using ROE and ROA are insignificant. Thus, H1 is accepted. The result in this study is in line with other past studies such as Shafie Mohamed et al., (2016) and Kumar (2016), who found board independence has positive impact on firm's ROA. Sharifah Faatihah Syed Fuzi et al., (2016) supported that independence directors are not bias and free from the influence of management, thus they can contribute their independent view in the board discussion and most importantly to safeguard a balance of power in the management.

The coeffient on board size for Tobin's Q is positive and significant at 1% level while for ROE and ROE are statistically insignificant. The positive impact of board size on Tobin's Q suggests that larger board size, the higher the firm performance, thus H2 is accepted. This finding is in line with the work of A.Arora & Sharma (2016), who found positive association between Tobin's Q and board size. In addition, C.Rose (2016) supportted larger board size is better than smaller board to enable all the members to pay active role in constructive debate and effective decision making processes. The diversity skills and expertise on the board will lead to better firm performance.

Tobin's Q and ROA show negative and significant coefficient for CEO duality. However ROE is not found to be associated with CEO duality. The result is consistent to support the recommendation in MCCG that CEO and the chairman should be separated. The similar finding is also documented by A. Duru et al., (2016) which found negative association between CEO duality and firm performance. S.Zhou (2014) argued that it is necessary for a firm to separate the leadership especially when the business environment has become more competitive and dynamic. Thus, the effectiveness of the board function and monitoring are better and this could lead to better firm performance.

Based on ROE and ROA models, board compensation is positive and significant at 1% level while Tobin's Q has no significant impact on board compensation. The similar result is also found by C.Rose (2016) and D. Vo & T.Phan (2013). The finding suggests that well-compensated directors will enhance their contribution towards the firm and which lead to high performance as the directors would act as in the best interest of the shareholders. In addition, L.E Brick et al., (2006) argued that board compensation is espected to be positively associated with firm performance as the difficulty of the directors's task to monitor the firm performance require the directors of having high level of skill and expertise. Most of the control variables in this study are found to be significant. All the three models show the negative and significant coefficient for firm size which imply that smaller firm size has high firm performance. The leverage has negative impact on firm performance when tested using ROE and ROA. All the models imply positive and significant coeffient with firm performance for profitability. Overall, the empirical results are consistent with the previous studies which support that corporate governance does influence firm performance.

5. Conclusion

This study addresses the question whether the revised MCCG 2007 & MCCG 2012 influence firm performance in Malaysia. In line with the past studies, the findings support that independence directors, board size and board remuneration are positively related to the firm performance. Furthermore, the result also evidence that for firm in Malaysia, it is better to separate the role of CEO and the chairman as it will lead to higher performance. Thus, overall findings evidence that the recommendation in the MCCG to improve the governance structure of firm in Malaysia does improve the firm performance. For future research it is highly recommended to take into consideration of testing more companies from different industries.

Table 3: Multiple – Regression Analyses

Variables	Tobin's Q			ROE			ROA		
	β	T-Statistic	P-Value	β	T-Statistic	P-Value	β	T-Statistic	P-Value
BIND	0.189	4.634	0.000***	0.076	1.795	0.073	0.046	1.139	0.255
BSIZE	0.190	4.564	0.000***	0.006	-0.126	0.900	0.026	-0.632	0.528
DUALITY	-0.155	4.162	0.000***	-0.077	-1.958	0.051	-0.106	-2.884	0.004***
BCOMP	0.050	1.170	0.242	0.186	4.054	0.000***	0.142	3.394	0.001***
SIZE	-0.567	-11.935	0.000***	-0.504	-9.857	0.000***	-0.404	-8.708	0.000***
LEV	-	-	0.38	-	-	-	-	-	0.00

	0.036	0.867	6	0.223	5.144	0.000***	0.194	4.805	0***
PROFIT	0.257	6.514	0.000***	0.339	8.076	0.000***	0.220	5.632	0.000***
R-Squared	41.5%			34.20%			38%		
Adjusted R-Squared	40.7%			33.30%			37.2%		
F-Statistic (P-Value)	51.05 (0.000)***			37.89 (0.000)***			47.11 (0.000)***		
Firm-years	547			547			547		

Notes: *Significant at 10% Level; ** Significant at 5% Level; ***Significant at 1% Level.

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