

Corporate Governance Structures and the Performance of Malaysian Public Listed Companies

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Numerous studies have looked at the implications of corporate governance structures on company performance. Although the literature is not unanimous in its conclusions, the weight of opinion is that there is a significant relationship between governance structures and firm performance. The aim of this research is to study the effect, if any, of corporate governance structures, particularly board structure and CEO duality, on the performance of Malaysian public listed companies. The literature on these two governance parameters, board structure and CEO duality on firm performance in the context of Malaysia is lacking. Using samples of large publicly traded Malaysian companies, this research aims to examine the relationship between CEO duality and the proportion of independent directors on firm performance as measured by return on assets (ROA) and return on equity (ROE). Results show that there is no significant relationship between corporate governance structures and company performance.

Research Field: Corporate Governance

1. Introduction

The Asian financial crisis of 1997 resulted in most Asian countries seeking to strengthen their corporate governance, transparency and disclosure levels (Ho and Wong, 2001). In the case of Malaysia, it was suggested that the erosion of investor confidence in Malaysia was brought by the country's poor corporate governance standards and a lack of transparency in the financial system (Noordin, 1999b). Therefore, an effective system of corporate governance controls is considered crucial in aligning the interests of directors with those of shareholders. The board of directors has its key role in corporate governance, their main responsibility is to endorse the organisation's strategy, develop directional policy, appoint, supervise and remunerate senior executives and to ensure accountability of the organisation to its shareholders, authorities and other stakeholders. The relative effectiveness of corporate governance has a profound effect on how well a business performs. Most of the literature on corporate governance identifies board characteristics and their impacts on the organizational outcomes. Previous studies have examined the effects of such factors as board size (Dalton et al, 1999; Pfeffer, 1973; Pfeffer and Salancik, 1978; Singh and Harianto, 1989) and board composition (Baysinger et al, 1991; Chaganti et al, 1985; Kosnik, 1987; Schellenger et al, 1989) on strategic decisions and organization performance.

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The Board structure comprising of executive directors and independent directors (also known as 2-tier board) with mixed skills from varied background is recognized for their contribution in the organization. Executive directors have direct responsibilities to manage the company's business and resources, while independent directors are responsible to bring an independent judgment to bear on the issue of strategy, performance and resources including the key appointments and standards of conduct. The field of independent directorship is in no way risk free; it should not be treated lightly. It carries significant exposures, financial liability, possible disqualification and consequential damage to future careers. An independent director legally bears the same responsibilities as the Executive Directors, but achieves effectiveness by influencing decisions rather than controlling operations. An independent director is a non-executive director on the board of a company who has integrity, expertise and independence to balance the interests of various stake holders. The idea of having them is to bring objectivity to board decisions and to protect general interests of the company, including that of minority shareholders. Independent directors are expected to improve the level of compliance of corporate governance of a company.

The Malaysian Code on Corporate Governance is the main cornerstone of the corporate governance reforms agenda in Malaysia. It provides guidelines on the principles and best practices in corporate governance and the direction for the implementation as well as charts the future prospects of corporate governance in Malaysia. Corporate governance plays the main role in company performance because it assists to control the board's performance in business operations. To ensure the accountability towards shareholders, the board of directors of a company shall consist of at least 2 persons or 1/3 of the independent directors as set out in the Listing Requirements of Bursa Malaysia. The Code promotes the same to the effective functioning of the board. The independent directors may contribute to the board to balance the board size and to work co-operatively with their executive colleagues and provide independent judgment when necessary. The risk is perhaps greatest where the roles of chairman and CEP are combined. It is here that the presence of a sufficient number of independent directors is crucial

There should be a clear acceptance of division of responsibilities between chairman and CEO, which ensures a balance of power and authority such that no individual director has unfettered power in the decision-making process. The aim of this research is to study the effect, if any, of board structure and CEO duality on the performance of Malaysian public listed companies. The literature on these two governance parameters, board structure and CEO duality on firm performance in the context of Malaysia is lacking. Using samples of large publicly traded Malaysian companies, this research aims to examine the relationship between CEO duality and the proportion of independent directors on firm performance as measured by return on assets and return on equity.

2. Literature Review

Firms which implement sound corporate governance systems provide more useful information to investors and its other stakeholders to reduce information asymmetry as well as to help the company improve its operations (Hsiang-tsai Chiang et al. 2005). But what is corporate governance? Corporate governance is seen as concerned with ways of bringing the interests of (investors and managers) into line and ensuring that firms are run for the benefit of investors (Mayer 1997). It has two-way relationship between internal governance mechanisms of corporations and society's conception of the scope of corporate accountability (Deakin and Hughes 1997). Therefore, corporate governance should be inclusive of the structures, processes, cultures and systems that engender the successful operation of organizations (Keasey et al 1997) was formed based on the concept of corporate governance as stated in the Cadbury Committee Report 1992 whereby corporate governance is the system by which companies are directed and controlled is generally accepted.

Malaysia began its reform of corporate governance in the 1990s. Bursa Malaysia is the front line regulator for all exchange traded securities and derivatives. The principle securities market in Malaysia is the Securities Commission while the Companies Commission of Malaysia administers the Companies Act, 1965, all with their own rules and regulations, have inter-alia established the foundation for corporate governance in Malaysia, prior to the introduction of The Malaysian Code of Corporate Governance ("MCCG") in the year 2000. MCCG provides principles and recommendation for best practice for corporate governance and disclosure requirements and therefore serves as a general guideline for the Malaysian public listed companies in ensuring their accountabilities towards all its investors as well as stakeholders.

Corporate governance and firm performance

There are many studies on the relationship between corporate governance and firm performance. One study shows that corporate governance has contributed to the company in enhancing operating performance and preventing fraud (Yeh, Lee, and Ko, 2002). The issue has also been evidenced that the performance of a firm is directly related to good corporate governance. Companies with better corporate governance have better operating performance than those companies with poor corporate governance (Black, Jang, and Kan, 2002) which was concurrent with the view that better governed firms might have more efficient operations, resulting in higher expected returns (Jensen and Meckling, 1976). It is also believed that good corporate governance helps to generate investor goodwill and confidence. Another study had demonstrated that the likelihood of bankruptcy is related to poor corporate governance characteristics (Daily and Dalton, 1994). Thus, it could be stated that the MCCG may be a mediating variable which influences the relationship of the independent variables and the dependent variable.

The Important Role of the Board of Directors

The board of directors plays an important role in the operation of a company. It oversees top management and is entrusted with the responsibility of monitoring and supervising the company's resources and operation. (The board's primary responsibilities have been discussed earlier in this paper). Therefore, the board is collectively seen as a team of individuals with fiduciary responsibilities of leading and directing a firm, with the primary objective of protecting the firm's shareholders' interests (Shamsul Nahar Abdullah 2004). There are three critical board roles that have been identified and studied by a variety of theoretical perspectives inclusive of service roles, control roles and strategic roles (Zahra and Parce 1989, Gopinath et al. 1994, Maassen 1999). This has been further elaborated in a different study that the board should alternatively fill an auditing, a supervisory, a coaching, and a steering role (Strabel 2004). However, the separation between ownership and control mechanism in today's modern organization has resulted in a potential conflict of interest situation (Berle and Means 1932). This is also a consequences of the agency theory in which the self interest of the management is likely to lead them to involve in value-decreasing activities (Jensen and Meckling, 1976). The predicted reduction in value of the firm as a result of the management opportunistic behavior is known as "agency costs" (Jensen and Meckling 1976).

CEO Is Chairman of Board Of Directors (CEO Duality)

There are two types of leadership structure, that is, combined leadership structure and separated structure (Coles et al 2001). A firm may adopt the combined leadership structure in which the CEO is also acting as chairman of the board whilst the separated structure clearly divides the positions of CEO from chairmanship. MCGG recommends that the role of CEO and Chairman should be distinct and separated to ensure the balance of power of the two designations as well as to avoid conflict of interest. It is also to avoid a single person in the board to dominant the others in decision making process so to promote fair judgment and reasonable concern. If there is a duality, MCGG recommends that strong independent element should be included and such information be disclosed to the public for transparency purpose.

Many studies have been done to identify the implications of CEO duality. There is a claim that the operating performance may be improved as a result of less conflict between the CEO and chairman and/or other directors (Anderson and Anthony 1996). Those firms which have been identified as earnings manipulators are more likely to have a CEO who also serves as a board chair (Dechow et al.1996). The CEO duality in fact has a positive effect on firm performance under certain industries (eg. resource scarcity or high complexity) (Donaldson and Davis 1991). However, one study shows that the lack of separation from the CEO has lead to corporate board being aligned with management rather than shareholders notwithstanding the presence of independent directors (Greenspan 2002-2003). Not only that, those firms which practice CEO duality are likely to have lower shareholder returns (Rechner and Dalton 1991).

The relationship between CEO duality and firm performance is considered neutral/insignificant in certain studies whereby there is no link between CEO duality and firm performance (Berg and Smith 1978). No significant relationship was shown in a different study done using Malaysian public listed companies as sample (Allen Chang 2004). Although the literature is not unanimous in its conclusions, the weight of opinion is that there is a significant relationship between CEO duality towards firm performance.

Independent Directors

Bursa Malaysia underscores the importance of having independent directors on boards by its Revamped Listing Requirements by ensuring the board of directors of Malaysian public listed companies has a sufficient independent element to safeguard the interest of investors. The role of independent directors on the board of directors is to effectively monitor and control firm activities in reducing opportunistic managerial behaviors and expropriation of firm resources (Fama and Jensen 1983a,b, Brickley et al. 1994). However, independent directors face difficulties in discharging their duties as they are not directly affiliated with the management (Weisbach 1988). There is evidence to show that independent directors are valued for their ability to advise, to solidify business and personal relationships, and to send a signal that the company is doing well rather than for their ability to monitor (Mace 1986, Herman 1981). Nevertheless, a study of Singapore's directors has indicated that most of the respondents were of the opinion that the optimum level of independent directorship is between 25% and 50% of the total size of the board and the independent directors were more convinced that strong corporate governance enhanced the board effectiveness more than executive directors (Goodwin and Seow 2000). As such, the proportion of independent directors is identified as the other independent variable in this study.

Numerous studies has evidenced that the proportion of independent directors is correlated to firm performance (Agrawal and Knoeber 1996). Companies with more independent directors tend to be more profitable than those with fewer independent directors (You et al. 1986). In addition, firms that substantially increase the proportion of independent directors have above-average stock price returns (Dennis and Sarin 1997). Conclusion has also been made that increasing the level of the proportion of independent directors should simultaneously increase firm performance as they are more effective monitors of managers (Adams and Mehran 2003). There were other views which are totally different from the above. Some researchers found that although the proportion of independent directors on the board is high, the level of board independence and professionalism is not necessarily good (Chen, Fan and Wong 2004). The relationship between the proportion of independent director and firm performance was found to be negative (Klein 1998, Agrawal and Knowber 1996, Yermack 1996). It has been further argued that there is no relationship between the proportion of independent directors and superior firm performance (Hermalin and Wesbach 2001). Based upon the literature, the relationship between proportion of independent directors and firm performance will be investigated in the study.

3. Theoretical Framework and Hypotheses

The framework represents a model which concerns ascertaining the relative importance of the known antecedents of firm's performance. Many researchers found that CEO duality and the proportion of independent directors to board size gives indirect impact towards the firm's performance but for the purposes of this study, the research question is whether the implementation of the principles of the Malaysian Code of Corporate Governance impacts firms' performance. So, in measuring firm's performance, valuation of Return of Equity (ROE) and Return of Assets (ROA), where profit before interest and tax will be used as denominator because it shows the real performance of a firm as the dependent variable. CEO duality is set as the binary variable and board independence, the number of independent directors to board size, is the independent variables in measuring the relations to firm's performance. The Malaysian Code of Corporate Governance (MCCG) is used as the moderating variable.

The main characteristic of MCCG identified in this study is CEO duality and the proportion of independent directors. Firm performance is the dependent variable. Past researchers applied different methods in measuring firm performance such as stock price, dividend payable, return on assets, return on equity, gearing ratio and so on. In this study, return on assets and return on equity are used as indicators for firm performance. CEO duality occurs if the roles of chairman and CEO are combined. The chairman of the board is responsible for managing the board, which may include tasks such as selecting new board members, monitoring the performance of the executive directors and settling any conflicts which arises within the board. The CEO is responsible for the day to day management of the company, including the implementation of board decisions.

The companies that practices CEO duality, may have an individual who posses too much power and might make decisions that do not maximize shareholders wealth. Interest in duality has emerged primarily because it is assumed to have significant implications for organizational performance and corporate governance. Duality is often cited as a primary cause for the decline of major US corporations such as Westinghouse, Sears, General Motors (GM) and IBM. In 1992 GM lost \$23.5 billion and its market share dropped by 34.5%. At that time, Roger Smith was both the CEO and chairman of General Motors. Operating performance may improve as a result of less conflict between the CEO and the Chairman (Anderson and Anthony, 1996). The lack of separation has lead to corporate board being aligned with management rather than shareholders notwithstanding the presence of independent directors (Greenspan, 2003). In relation to the Malaysian Code on Corporate Governance (2000), there is a requirement of balance of power and authority between Chairman and CEO so that no one individual has unfettered powers. Drawing from the literature on the relationship between a firm's performance and CEO duality, the following hypothesis is made:-

H1: CEO duality has a significant relationship to firms' performance

The Cadbury Committee recommended that there should be at least three non executive directors on the board of quoted companies. Board independence is associated with the entry of outsiders into the board and Cadbury Committee outlined the reasons for having an outside presence on the board as:

- Outside directors broaden the strategic view of boards and they widen a company's vision
- Outside board members ensure that boards always have their sights on the interests of the company. They are well place to resolve conflicts.
- The outside directors bring awareness of the external world and ever changing nature of public expectations to board discussions,
- Outside directors have a clear role in appointing and monitoring the executive team.

In the Malaysian context, the Listing Requirements of Bursa Malaysia Securities Bhd (Formerly known as the Kuala Lumpur Stock Exchange) which was revamped in January 2001, required at least one third of the board to comprise of independent directors. The term independent as described by the Malaysian Governance Code refers to independence from management and significant shareholders. The literature suggests that increases in the proportion of outside directors on the board increases firm performance as they can more effectively monitor managers (Adams and Mehran, 2003). Drawing from this tread in the literature on the relationship between independent directors and firms' performance, the following hypothesis is made:

H2: Proportion of independent directors to board size has a significant relationship to firms' performance

The Malaysian Code of Corporate Governance provides a foundation in corporate governance and simultaneously provides the direction for the implementation as well as charts the future prospects of corporate governance in Malaysia. Therefore, to test the impact of the implementation of the MCCG on the firm performance, the following hypothesis is made:

H3: The implementation of MCCG has a significant impact on firms' performance

4. Methodology

In this section, the methods employed in the study in testing the research hypotheses are described. The specifics of data collection, and the methods applied to empirically assess the proposed framework are described. The sample consists of 100 Bursa Malaysia companies, comprising 30 large companies and 70 mid-sized companies. However, financial institutions are excluded as they are subject to a different regulatory framework which does not apply to other listed companies. In addition, their final accounts are also differently structured and therefore accounting performance comparisons are not straight forward. Data was obtained via the webpage of Bursa Malaysia Securities Bhd for the published annual reports for FY

1999 (prior to the implementation of MCCG) and FY2005 (after the implementation of MCCG in 2000).

MCCG was implemented in 2000 and therefore represents the governance situation prior to its implementation. The data for 2005 data is expected to represent the governance situation 5 years after the implementation of the MCCG. The sample therefore would allow the results to be compared before and after the implementation of the MCCG. Further analysis will also be carried out to identify the link between companies which have made moved in line with the MCCG and those which did not.

The variables that will be used in the analysis are as follows:-

Dependent Variables

- (i) ROA – return on assets (Profit before interest and Tax / Total Assets) x 100
- (ii) ROE- return on equity ((Profit before interest and Tax / Total Equity) x 100

Independent Variables

- (i) Duality - This is a binary variable which has a value of one if one individual has the joint title of chairman and CEO or if one individual has the executive position and there is no separate CEO. If the posts are separate, it is zero.
- (ii) Proportion of independent directors (NED) - This measures the number of non executive directors on the board. There will be 2 comparisons
 - NED 33 - This measure will include binary number of one if the independent directors represent at least one third of the board. Binary number zero represent if the independent directors is less than one third. We expect firms which have more than one third of the board to perform better.
 - NED 50 - This measure will include binary number of one if the independent directors represent 50% of the board. Binary number zero represent if the independent directors is less than 50%. We expect firms which have more 50% of independent directors to perform better than firm which do not.

SPSS Statistical Package was used along with a number of statistical techniques in measuring the relationship between the dependent variable and independent variables. Non parametric tests were conducted since ROE and ROA were not distributed normally. Mann Whitney U Test will be conducted to test the hypotheses. This tests the hypotheses that two independent samples comes from populations having the same distributions. The test is equivalent to the independent group's t-test.

5. Results

Duality and Board Structure

	1999	2005
Duality	15.9%	8.6%
NED33	52.3%	90.4%
NED50	2.3%	26.5%

Table I: Percentage of Companies with Duality and Board Independence

In general, there were more companies with duality in 1999 than in 2005. This is shown in Table I above. In 1999, 15.9% of companies had same person for CEO and chairman of board of directors, compared to 2005 with only 8.6% of the companies having the same person. This is more than twice the number of companies with duality in 1999 compared to 2005. In contrast, the table shows that more companies had a higher proportion of independent directors in 2005 compared to 1999. Table I shows that 90.4% of companies had the minimum one third number of independent directors on their boards compared to only 52% of the companies in 1999. This may be the result of the implementation of Bursa Malaysia's Revamped Listing Requirements in 2001 which required all listed companies to have a minimum of 2 or one third independent directors, whichever was higher. In 2005, 26.5% of the companies had more than 50% independent directors on its board which is significantly higher than 2.3% in 1999.

Performance Based on Duality and Board Independence

Table II and Table III below compare the performance of companies with duality and board independence with those without duality and board independence for the years 1999 and 2005.

1999		ROA	Z value	ROE	Z value
Duality	N=7	14%	-0.49	17.7%	-0.209
No Duality	N=37	12%		22.1%	
NED33					
>= 33%	N=23	12.9%	-0.55	24.1%	-1
< 33%	N=21	11.6%		18.4%	
NED50					
>=50%	N=1	4.5%	-1.22	9.2%	-1.3
< 50%	N=43	12.5%		21.7%	

Table II: Performance of Companies With and Without Duality and Board Independence, 1999

Table II above shows that in 1999, only 7 companies had duality whereas 37 did not. Companies with duality had higher ROA (14%) than those without duality (12%). However, in terms of ROE, those companies with duality had a lower ROE (17.7%) than companies without duality (22.1%). The result shows that the separation of

CEO and Chairman of BOD does seem to improve performance in terms of ROE but not in terms of ROA.

The results for board independence and performance are inconsistent for the year 1999. Table II shows that NED50 companies that had more than 50% independent directors on the board (NED50), had lower ROA (4.5%) and ROE (9.2%) than companies that had fewer independent directors (< 50%). The ROA and ROE for these companies were 12.5% and 21.7% respectively. However, for NED33 companies, those that had more than 33% independent directors performed better with ROA of 12.9% and ROE of 24.1% respectively, than those who had less than 33% independent directors with ROA of 11.6% and 18.4% respectively. The results seem to support the MCGG recommendation that requires companies to have at least one third independent members on the board.

In terms of the Z value scores, there is no significance among the variables and ROA/ROE value for the 1999 data. In order for there to be a significant correlation, Z values must be below -1.96 or more than 1.96. So, based on the 1999 data, duality and number of independent directors do not have a significant impact on the performance. Similarly, Table III below shows the comparison between the variables and ROA/ROE. As in 1999, in 2005 companies with duality have better ROA (13.8%) than those that do not (10.9%). However, again in terms of ROE, the results show that companies with duality have a lower ROE (20.1%) than companies without duality (22.2%). As for 1999, the results for 2005 show that the separation of CEO and Chairman of BOD does seem to improve performance in terms of ROE but not in terms of ROA.

2005		ROA	Z value	ROE	Z value
Duality	N=7	13.8%	-1.4	20.1%	-0.57
No Duality	N=74	10.9%		22.2%	
NED33					
>= 33%	N=75	11.38%	-0.97	23%	-1.01
< 33%	N=8	7.1%		10.6%	
NED50					
>=50%	N=22	10.3%	-0.24	29%	-0.79
< 50%	N=61	11.2%		19.2%	

Table III: Performance of Companies With and Without Duality and Board Independence, 2005

The results for independence for year 2005 also show the same characteristic as that of the 1999 data. For NED33 companies, those with more than 33% independent directors, the ROA (11.38%) and ROE (23%) were higher than those with less than 33% independent directors, where ROA and ROE were 7.1% and 10.6% respectively. There is some inconsistency on the part of NED50 companies. In terms of ROA, companies with less than 50% independent directors show slightly better performance (ROA 11.2%) than those with more than 50% independent directors (ROA 10.3%). However, in terms of ROE there is a greater difference in performance between companies with more than 50% independent directors (ROE 29%) compared to those with less than 50% (ROE 19.2%). However, as for 1999, there is no significant correlation between the variables and ROA/ROE. All the Z

values are between -1.96 and 1.96 which means that there is no significant correlation.

Impact of MCCG on Performance

In this section we will look at the impact of the Malaysian Code of Corporate Governance (MCCG) on company performance with reference to duality and board independence.

2005		ROA	Z value	ROE	Z value
Duality					
Move away from duality	N=4	13.42%	-0.7	10.28%	-0.35
Retain duality	N=3	14.17%		19.64%	
NED33					
Change to more than 33%	N=16	10.93%	-0.49	17.82%	-0.25
Still less than 33%	N=5	7.9%		16.79%	
NED50					
Change to more 50%	N=9	13.1%	-0.86	20.5%	-0.32
Still less than 50%	N=34	11.58%		21.35%	

Table IV: Impact of MCCG on Performance

Table IV above shows the performance of companies after the adoption MCCG recommendations on duality and board independence. In terms of duality, the results show no difference with the previous results. Companies that retained duality have better ROA than those who moved away from duality. ROE analysis shows the opposite result. Companies who moved away from duality have better ROE than those who did not. In terms of board independence, companies that increased the proportion of independent directors from below 33% to more than 33%, show better performance than those that still retained the proportion of independent director to less than 33%.

Companies that increased the proportion of independent directors to more than 50% have better ROA rather than those that maintained less than 50%. In terms of ROE, the results show an opposite direction. Companies that retained its proportion of independent directors to less than 50% show better ROE, though the difference is not significant than those that did not. Again, as in the previous analysis, the variables changes do not have a significant correlation with the changes in company performance. The Z values are between -1.96 and 1.96 (not significant).

Compliance with MCCG

Finally, we will look at the MCCG compliance for both 1999 and 2005 data. Companies are considered compliant with the MCCG if they have more than 33%

independent directors and also appoint different persons to sit as CEO and Chairman of the board (no duality).

		ROA	Z value	ROE	Z value
1999					
Full Compliance	N=18	14.2%	-0.95%	26.7%	-0.38
Less Compliance	N=26	11%		17.7%	
2005					
Full Compliance	N=67	11.44%	-0.07	23.5%	-0.43
Less Compliance	N=14	9.5%		14.8%	

Table IV: Compliance with MCCG

Table IV above shows that in 1999, companies who fully complied with MCCG had better performance to those who had lower compliance. The same is also true for 2005. However, correlation test results shows us that there is no significant correlation between the MCCG compliance and company performance.

6. Conclusion

The impact of CEO Duality and proportion of independent directors on company performance has received close attention by researchers in corporate governance in recent years. This study hopes to contribute to this line of research. Based on the results of this study, it was found that there is no significant relationship between duality and board independence to company performance.

7. Limitations and Future Research

The study focuses on board structures and CEO duality to draw conclusions on corporate governance and financial performance. This is a limitation. The results obtained cannot be generalized to say that there is no relationship between corporate governance and financial performance. Many other studies show otherwise. Also, the use of ROA and ROE as proxies for financial performance has its limitations. A more robust indicator would include more than two proxies for financial performance. This study focuses on the internal processes of a company. But external factors have a significant impact on company performance. Inflation, foreign exchange, macro economy, and interest rate policy may have a more significant impact on company performance than on how a company is regulated internally. This study could be extended to include analysis on other corporate governance issues such as board size, board compensation, ownership structure which impact upon performance. The study could also be augmented with a study of the qualitative aspects of the board that contribute to firm performance, such as the board decision-making process. [4977 words]

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