Corporate Governance and Firm Performance: Evidence from Listed Malaysian Firms

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Abstract---*This study examined the relationship between corporate governance and firm performance with the sample data of 180 listed companies of Malaysia during the period 2013-2017. This study employed the Tobin's Q and ROA as the proxies of firm performance, and ownership concentration, non-executive directors and board size are employed as the proxies of corporate governance. The results show a significant association between corporate governance and firm performance when non-executive directors and board size are used as proxies of corporate governance, but not significant when ownership concentration was used as a proxy of corporate governance. This study contributes to the field of corporate governance and organizational performance as it was found that better corporate governance leads to high firm performance. Further, this study provides insight to regulators who are interested in improving governance in developing economies.*

Keywords---*firm performance, corporate governance, MCCG, FCCG, Tobin's Q, ROA, ownership concentration, non-executive directors, board size.*

I. Introduction

The relationship between corporate governance and firm performance is extensively been recognised in previous literature. It is argued that the asymmetric actions taken by the management may lead to principal-agent conflict. The main objective of corporate governance is to protect the shareholders' interest by pursuing the management to govern the firm in the direction, which is favorable for shareholders. The self-interest of managers drive them to misuse the corporate assets, for instance they are trying to pursuit the investment projects, which are overly risky at the expense of capital provider(Pillai & Al-Malkawi 2018). To overcome the agency conflict and avoid the unwanted agency cost, there are various external and internal mechanisms introduced, which were all derived from corporate governance. These mechanisms include debt financing, ownership structure, influence of insider and outsider shareholder and market for corporate control. Jakpar et al., (2019) comprehend in his study that the importance of corporate governance is promoting continuously in the Asia pacific region because it provides the efficient use of resources within the firm and the economy as a large. Corporate governance also assisting the firm to gain the confidence of investors and creditors and enable the firm to attract the low cost investment capital. Aydin &Ozcan (2015)explain that corporate governance put some societal responsibility to the firm and in return ensure the increasing performance of the firm in long term. In other words the performance of the firmmay reflected by the efficiency of its governance system and the practices they are following to manage the firm.

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Previously the management and the board of directors have been criticized for the firm performance because shareholder's wealth depends on the firm's performance and if the shareholder's wealth is on the declining trend than it may result in the corporate failure. There is some corporate failure like Enron, Global Crossing and WorldCom that are the best example of misleading information about management and lack of director's decision. One of the reasons for bad firm performance is the lack of business knowledge with board members and they depend on the management decision which may be biased in the favor of their benefits.

There are some major corporate collapses in different developed stock markets in the past era, results in the establishment and enhancement of firms governance structure especially inthe first world countries (e.g. Hampel and Higgs Reports in the UK, the Business Roundtable in the US, the Cadbury and the Bosch Report in Australia). In the same way the crashof south East Asian stock market at the economic crisis of 1997-1998 was somehow due to the weak corporate governance(Leong et al., 2015). As a result, the new corporate code of governance were established by most of the countries in the region to make sure the consistency of funds inflow in theirstock market.Therefore the Malaysian government also realizes that the lack of corporate governance is thereason that crashes the stock market and they start working on the governance structure with the aim of increasing the investors' confidence.

Malaysia hasits own corporate code of governance known as Malaysian Corporate Code of Governance (MCCG). The MCCG was formally developed and established in year 2000 and widely based on the recommendation of developed countries. Although the economic environment of Malaysia is largely different from that of UK and US inall aspect, therefore it is way difficult to apply their governance structure in Malaysia. Moreover there were no system in which the management are accountable for their intentions of making decision either in shareholders' interest or their own. In such situation, the agency conflict arises and mainly between managers (agents) and shareholders (principals). Such conflictsnegatively affect good governance and becomes the reason to damage the company's image in the market. There have been many prior studies that tried to find solutions to the principal-agent problem however, this issue still exists in different forms.

Besides, several studies have founda significant relationship between corporate governance and firm performance (Bhatt & Bhatt 2017; Arora & Sharma 2016). However, this study employed three proxies of corporate governance i.e. Ownership Concentration, Board Size and Non-Executive Director, and two proxies of firm performance i.e. ROA and Tobin's Q to examine the association between corporate governance and firm performance using Malaysian firms' data. The results found a significant relationship between corporate governance and firm performance when non-executive directors and board size are used as proxies of corporate governance, but not significant when ownership concentration was used as a proxy of corporate governance. The findings of this study contributes to the field of corporate governance and organizational performance as it was found that good governance leads to better firm performance.

II. Literature Review

Strong governance structures is an important tool to secure the shareholder's wealth and act as early warning systems to keep the firm out of danger. Saha et al., (2019) noted that there is a big difference between western countries and Asian countries' business structures in terms of the relationship between corporate governance and firm's stock value. Prior studies indicates that the western world has a strong practice of corporate governance whereas Asian countries have very weak practices. In Asia, there are very few countries that have strong corporate

governance practices like Malaysia, Indonesia, Singapore, and Thailand. The previous empirical analysis also showed that the higher the standard of governance the stronger the association of governance and firm value.

Initially the activity of improving corporate governance practices in Malaysia was started in the early period of 1993. This campaign of improvement was especially started for the listed companies of BURSA when the audit committee become the mandatory part of listed firms (Azeez, 2015).Later on Malaysian security exchange commission emphasis the MCCG to shift the regulatory regime from merit-based to disclosure-based in order to increase the confidence of investors. Although the economic crisis of late 90's causes the number of corporate failure of 'blue chip' likewise, KFC, UEM, Renong, etc. All these corporate failure reported as the result of weak corporate governance mechanism. Right after that Malaysian government started intervene in the issue and offer them the rescue packages. The most important action taken by the Malaysian government was the establishment of high level 'Finance Committee on Corporate Governance' (FCCG) in order to improve the effectiveness of corporate governance. This committee comprises of the senior personal of different regulatory bodies, professional bodies, senior government representatives and other experts with the intension of reviewing the current corporate code of governance and recommend the possible transformation in order to make it more effective.

The main agenda of the FCCG committee is to find the loopholes in the governance structure and propose the legal reforms in order maximize the shareholders' protection. The analysis report of FCCG committee indicate a number of loopholes in the governance structure which were mainly due to the ownership structure of the firms, incompetent board of directors, misuse of powers, weak minority protection and irresponsible directors(Suffian et al., 2017). The ownership concentration is not simply influenced by the management and control problem like other countries. In case of Malaysia the ownership structure is mainly concentrated by families or a single party or five largest shareholders. In this scenario the minority shareholders have to experience the high level of risk (Aguilera &Crespi-Cladera 2016).The role of directors especially non-executives are always doubtful as their responsibility is to monitor the activities of management but they are often seen busy in activities which has nothing to do with their responsibility(Dias et al., 2017).

In addition to this, previously these directors were the owner of small businesses before the economic revival of early 90s. After that they have become the directors of business groups overnight,taking into account the fact that they have no idea of corporate governance, statutory responsibilities, and complex business laws(Khanna, 2017). Considering this issue, it is the desire of both the domestic and the international shareholders that the listed companies should have the strong corporate governance structure which will protect the rights and investmentsof the minority shareholders.

The revised Malaysian code of corporate governance (MCCG) was issued by FCCG in March 2000 which was based on the proposed code of corporate governance considering the underline issues Malaysian stock market had to face in the economic crisis of 1998.These code were derived with the coordination of developed countries and largely based on Hample Report (1998) and Cadbury Report (1992) which is belongs to UK. The proposed set of codes are not very descriptive in nature instead it was like a set of rules which consists of four main headings which are given below:

- Principles

- Best practices
- Exhortations to other participants
- Mere best practices

The first heading “principles” contains all the key issues related to the performance elements of the firm that are: The board of directors, the compensation of directors, the accountability at all levels and the effective audit committee. The theme of these principles are very simple and easily understandable for the stakeholders. The flexibility and simplicity of these principle would increase the transparency for investors and enable all the listed firms to implement them easily. The stated feedback of the principles in the annual report is positive and perceived as the guideline for investors and directors. It provide the sufficient disclosures to analyze the performance and the corporate governance practices of the firms and also enable the investors and stakeholders to assess their future decisions. The “best practice” defines a direction that follow the practices and guidelines established by the corporate governance in which the board of directors are accountable and auditable. It will encourage the firm to govern according to the transformed corporate governance structure. Moreover, the compliance of the best practices is voluntary but it is mandatory to provide the details in annual report, at what extent the firm is compliant with the practices and justify the uncompliant practices in details. The third headings “Exhortations to other participants” is entirely related to the investors and auditors which assess them to improve their role in corporate governance. The recommendation and explanatory note on the first three headings are referred to as “Mere best practices” which is consider to be the open platform for suggestive improvement.

Therefore MCCG recover investors’ confidence by providing them effective corporate governance mechanism and enable them to recommend the required changes in the system. This would also increase the trust level of shareholders on management as they are bound to take decisions under the define framework of corporate governance and ultimately improve the firm performance.

Previously many studies have found a positive relationship between corporate governance and firm performance. The weak corporate governance structure cannot protect the minority shareholders. In case of Malaysia the ownership structures are imbalance as the majority of the firms are owned by the family or in other cases majority of the shares are owned by popular five shareholders. Various empirical analysis explains that the frim performance is mainly dependent on ownership structure. Kaur et al., (2018) explained the relationship between firm performance and the stock owned by the management as the more the stock owned by the management the better the performance would be. Proportion of stock owned by the management aligns the degree of interest took by the managers and that results in the minimization of the principal-agent conflict. Broadstock et al., (2019) found that an increase of a one percent in managers pay results in an increase of around ten percent of the firm’s value. These results show that the relationship between managers pay and firm performance is positive but not attractive in terms of value. These results also show that the remuneration policy of the managers is no attractive and they are not getting what they deserve. Naciti, (2019)argued that since managers don’t have complete ownership of the firm hence, they don’t get the total income gained by the firm, therefore they don’t put their best efforts to increase the firm performance. It is observed that as a result of the agency problem, both parties are always trying to maximize their own interest.

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Recent studies focus on the ownership structure in which shares are owned by management. This includes the shares owned by managers, the CEO and the member of the corporate board. In this situation, there is a strong bond among the shareholders due to which the firm set free from agency problem and assume that all the shareholders may have the common interest. This would not be a case that if a person does no owned enough share to sit on the board but he is the member of the board because he is representing someone else who owns the larger number of shares. These kinds of board members may not align with professional management. Most probably their interest is more likely to align with those of outsider investor who cannot sit on the board. Usually, the insider board members and outsider investors have a conflict of interest. (Harold et al., 2001) find the correlation between the fraction of shares owned by the important shareholding families and the shares owned by management is 0.67. This positive correlation explains that important family shareholding has the power to represent themselves on the corporate board. However the family members and their representatives usually have a conflict of interest with managerial shareholders. Therefore, a high level of managerial ownership does not consider as so reliable because they will not protect the investor's interest.

While studying corporate performance, researchers review the characteristics of corporate governance including, board composition, board size, ownership concentration, insider and outsider shareholders and multiple directorship. The relationship between these characteristics and firm performance does not show the consistent results. Prior evidences shows that board size does not affect the firm performance. Samuel, (2017)suggest that the board should be small as their responsibility is to monitor and control the activity of management and take part in decision making process. Small board are considered as effective as they focus on resolving the issues and effort on improving the firm performance. Whereas the large board become the symbol of power and getting involve in personal rivalries(Ghabayen et al., 2018).Although the large board may perform positive and productive for the firm performance and provide diversified option for the development of the firm and may reduce the environmental uncertainty for the firms(Paniagua et al., 2018).The recommended board size would be between eight to nine members and any additional services taken by the extra member would be charged as expense for the ease of CEO(Hou et al., 2017).Tulung&Ramdani (2018) use the data of large US firms to find the relationship of board size and firm performance and the results were significantly negative based on the Tobin's Q model.

The MCCG codes played a vital role to improve the performance of the firm and increase the stock value in the market. But there is still some factor that needs to be defined. As several previous studies showed inconsistent results related to corporate governance and firm performance where it could be significant or non-significant and positive or negative, depending on the sample data. There is much research done in the past that demonstrate that effective corporate governance bound the management to work in favor of the firm that would definitely results in the better performance.

H1: There is a significant relationship between ownership concentration and firm performance.

The MCCG suggest that board should comprises of one-third of non-executive directors in order to balance the concentration of executive directors and to monitor the management activities. Therefore our second hypothesis:

H2: There is a significant relationship between the ratio of non-executive directors and firm performance.

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The MCCG does not criticize the board size in any aspect. Small boards are seem to be more effective in decision making. Whereas the larger board provide the diversified options to secure the critical resources and built up the contacts. So our next hypothesis:

H3: There is a significant relationship between board size and firm performance.

III. Methodology

Data and Sample

In this study, we collect the data from the non-financial companies listed on the stock exchange of Bursa Malaysia during the financial period of 2013 to 2017. This study selected 180 listed companies with the observation of 900,having classification of different business sectors. The corporate governance structure data is collected from the extracted data of companies' financial statements. Firm performance is the dependent variable in this study and, Tobin's Q and return on asset (ROA) are considered as the proxy to measure the performance. The value of Q indicates the effectiveness of governance structure and the market perception of firm performance. Likewise, the ROA values indicates that how much the asset of the firms are using with the intension of maximizing shareholders' financial interest. Both performance measure had also been used previously for various studies and the results were mixed.

There are three independent variable we use in this study to measure the corporate governance namely OWC (ownership concentration), NED (non-executive directors) and BSIZE (number of board members).Now the most important objective is to discover the systematic relationship of corporate governance and firm performance. To achieve this objective we have two performance equation, one for the Tobin's Q and second for the ROA. In first step we put the independent variable in Tobin's Q equation and in the second step we put the independent variables in ROA equation in order to find the correlation between corporate governance and firm performance. The estimation equations are as under:

Equation 1

Firm Performance =

$$Tobin's\ Q = \alpha_1 + \beta_1 OWC + \beta_2 NED + \beta_3 BSIZE + \sum_{i-1}^{n} \beta_i\ OTHERS$$

Equation 2

Return on Asset =

$$ROA = \alpha_1 + \beta_1 OWC + \beta_2 NED + \beta_3 BSIZE + \sum_{i-1}^{n} \beta_i\ OTHERS$$

In the above equations, we evaluate the firm performance by using both measures that are the Tobin's Q and the accounting profit rate. We consider that Tobin's Q takes both the ratio of the firm's fair value and the debt value of the total asset. The corporate governance variables include the ownership concentration, the ratio of non-executive directors, and the board size.

Control variables

According to previous research, there are other factors that should be control while evaluating the firm performance with respect to corporate governance structure. SIZE known as the company size considered as the log of total assets of the company. Following Sadiq et al., (2019), SIZE is expected to be positively associated with firm performance and large firms are supposed to be well established and producing more profits. DEBT indicates the

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proportion of total assets which is financed by loans. It is expected to be negatively associated with firm performance (Zandi et al., 2019; Kalabeke et al., 2019). BIG4 is an indicator variable which is scored 1 if a firm is audited by any of the big four auditor and score 0 otherwise (Zandi et al., 2019).

IV. Results

5.1 Descriptive Analysis

Table 1 shows the descriptive analysis of dependent, independent and control variables. Tobin's Q and ROA are the dependent variable whereas OWC, NED and BSIZE are the independent variable and remaining are the control variables. These variables carried the data of those companies that are listed on Bursa Malaysia during the period of 2013 to 2017. The mean values of dependent, independent and control variables indicate that there is no serious issue of outliers and suggest that the data is normally distributed.

Table 1: *Descriptive Analysis*

Variables	Mean	Minimum	Maximum
Tobin's Q	39.4	26.6	51.8
ROA	12.43	3.42	30.13
OWC	0.48	0.1	0.8
NED	0.45	0.3	0.6
BSIZE	9.2	7	14
SIZE	5.61	4.18	9.24
DEBT	0.39	0.14	0.64
BIG4	0.41	0	1

Where:

OWC = Ownership concentration

NED = Ratio of non-executive Director

BSIZE = Number of board members

Correlation Analysis

Table 2 represents the correlation analysis of 180 companies listed on Bursa Malaysia. Results obtained from the correlation are positive and significant and also indicate that corporate governance structure is significantly correlated with Tobin's Q and ROA, which are the proxies of firm performance. Tobin's Q and ownership concentration is positively, but not significantly correlated with each other. On the other hand Tobin's Q have a negative correlation with NED and BSIZE with the coefficients values of -0.069 and -0.094 respectively. However, NED is significantly, but BSIZE is not significantly correlated with Tobin's Q, suggesting that Tobin's Q measures does not find NED and BSIZE as supporting element for the enhancement of firm performance. Tobin's Q have a positive and significant correlation with all the other control variables except APR. Tobin's Q and APR have a significant and negative correlation with the value of -0.154.ROA is the second performance measure which have a negative correlation with

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ownership concentration with the value of -0.026. Similarly the correlation of ROA with NED and BSIZE is positive and also significant with BSIZE with the value of 0.04 and 0.171 respectively. The correlation of ROA with other control variables are positive and significant except DEBT. ROA and DEBT have a negative correlation with the value of -0.241. BIG4 and LEV have positive correlation with both performance measure. The correlation of DEBT is negative with all the independent variables which shows that OWC, NED and BSIZE are not supporting the idea of increasing debt. APR have the negative correlation with NED with the value of 0.025.

Table 2: *Correlation Analysis*

Variables	Tobin's Q	ROA	OWC	NED	BSIZE	SIZE	APR	DEBT	BIG4
Tobin's Q	1								
ROA	-0.089***	1							
OWC	0.012	-0.026	1						
NED	-0.069**	0.04	0.045	1					
BSIZE	-0.094	0.171**	-0.043	0.045	1				
SIZE	0.213**	-0.103**	-0.077*	0.041	-0.057*	1			
DEBT	0.080**	-0.241**	-0.018	-0.045	-0.03	-0.107**	0	1	
BIG4	0.092*	0.461	0.021	0.042	-0.048	0.058*	0.081	0.023	1

**Significant at the 1% level. *Significant at the 5% level respectively.

Regression Analysis

Table 3 presents the results of regression equation based on the relationship of corporate governance and firm performance. The adjusted R^2 for each of the variable is 23% and 33% respectively. The interception of both variables is significant but Tobin's Q is positive and ROA is negative. The relationship between ownership concentration and Tobin's Q is positive but not significant. On the other hand the relationship of ownership concentration and ROA is negative. Hence both the performance measures are not consistent with our hypothesis H1 as both measures are not significant with ownership concentration. The relationship of non-executive directors and firm performance is significant but negative and consistent with our hypothesis H2. The relationship of board size and firm performance is also significant but positive with ROA and negative with Tobin's Q. Hence the results of Tobin's Q is not consistent with our hypothesis H3 but H3 is consistent with the measure of ROA. Therefore the board size have a significant relationship with firm performance, hence H3 is consistent with our study. All the Control variables

have positive relationship with firm performance. However, the DEBT have a significant and negative relationship with firm performance. Our results are consistent with the previous study of Haniffa&Hudaib (2006).

Table 3: *Regression Results*

Variable	Tobin's Q	
	Coefficient	Z
Intercept	1.342	3.162**
OWC	0.002	0.043
NED	-0.082	-1.738**
BSIZE	-0.09	-1.866**
SIZE	0.056	1.043
BIG4	0.233	0.237
DEBT	0.471	-3.411**

∗∗Significant at the 1% level. ∗Significant at the 5% level respectively.

Table 4: *Regression Results*

Variable	ROA	
	Coefficient	Z
Intercept	-2.144	-4.574**
OWC	0.02	0.401
NED	-0.02	-0.401*
BSIZE	0.108	2.011**
SIZE	0.098	1.572
BIG4	0.216	0.221
DEBT	0.262	-4.284**

∗∗Significant at 1%,∗Significant at 5%.

V. Conclusion

This study examines the relationship between three measures of corporate governance and two measure of firm performance. The results based on performance measures that is Tobin’s Q and ROA. According to our results ownership concentration play a positive role for the performance of the firm in Malaysian market. After the transformation of corporate governance structure by MCCG, there is a positive remarkable difference found in the performance of the firms. The non-executive directors does not affect positively on the performance of the firms as it was recommended by the Malaysian institute of corporate governance that every board should be comprises of one third of non-executive directors. It was suggested by the Cadbury Report (1992) and the Hampel Report (1998) in the UK but these are not applicable in developing countries. Mostly the non-executive directors are hired not because of their expertise but the political background as they have contacts to approach higher authorities. The relationship of board size and firm performance is significant with both measures but it is negative with the market returns. The large board size seen to be less effective as it is difficult to monitor the performance and cost a lot to the firms as the

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director's remuneration policies are rich. However, the MCCG suggest that the board size should not be specific for everyone it should depends on the requirement of the firm.

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