

THE INFLUENCE OF THE BOARD OF DIRECTORS' CHARACTERISTICS ON FIRM PERFORMANCE: EVIDENCE FROM MALAYSIAN PUBLIC LISTED COMPANIES

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Abstract

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This paper aims to investigate the influence of board characteristics on firm performance. The four boards of directors' characteristics that are of interest in this paper are: CEO duality, independent directors (ID), board size (BS) and board meeting (BM). Return on Assets (ROA) and Earnings per Share (EPS) are used as measurements for firm performance. Data were collected from secondary sources based on a purposively selected sample of 341 Malaysian Public Listed Companies throughout the period ranging from 2003 to 2013. The data were analyzed using the panel data regression model. Results of testing the influences between board characteristics and firm performance are found to be mixed. For example, board meetings showed weak and negative influences on firm performance while independent directors had weak and positive influences only on ROA. Based on the findings of this study, it has been observed that the present listing requirements, which aligned with the assumptions of agency theory, by the Malaysian Code on Corporate Governance (MCCG) and by the Bursa Malaysia requirements, might not be effective as expected in enhancing future firm performance.

Keywords: Corporate Governance, Board Characteristics, Firm Performance, Agency Theory, Malaysia Listed Companies

1. INTRODUCTION

Corporate governance from the view of the Organization for Economic Cooperation and Development (OECD) is more about the relationship among managers, board of directors, shareholders and other stakeholders, including suppliers, customers and employees (OECD, 1998). Corporate governance is considered a major player in any firm since the board of directors is essentially responsible for monitoring company performance (Finegold, Benson & Hecht, 2007), for protecting shareholders (Ponnu, 2008) and for monitoring the Chief Executive Officer (CEO) (Barclift, 2011). However, the roles of the boards of directors nowadays are under pressure since their roles have

become more challenging and include providing strategic planning and advice as well as assisting managing firms through a crisis period (Daily, Dalton & Cannella, 2003).

The relationship between corporate governance and firm performance has recently received significant attention, especially after the financial scandals of well-established organizations that occurred in the US economy in the earlier years of this decade, for instance, WorldCom and Enron collapse and many more others due to abuse of power by their board of directors (IFAC, 2003), which might seem to act in their own best interest rather than for the company as a whole.

In Malaysia, corporate governance reforms began as a reaction to the various criticisms that

Malaysia faced during the Asian crisis of 1997-1998 and several steps have been taken. As a first step, the Malaysian code on corporate governance (MCCG) was issued in 2000, which largely followed recommendations of the UK code and became compulsory for all Malaysian listed companies to comply with in July 2001. This code is mostly aligned to the agency theory perspective in order to recapture investors' confidence, protect minority shareholders and enhance performance (Norwani, Mohamad & Chek, 2011). The Malaysian code was revised in 2007 and 2012 to conform to the global development of capital markets. Specifically, the code was revised to strengthen the board's effectiveness through its composition and by strengthening its independence (Securities Commission, 2012). Such code highlights the composition of the board and the importance for the independent directors to ensure that the board's decision making is not controlled by a specific party.

Despite the efforts to improve best governance practices in Malaysian companies, many argued whether the same requirements of corporate governance practices in the UK code can work effectively in a country which has a different legal system, business culture and corporate structure (Haniffa & Hudaib, 2006). To date, there is a lack of clear evidence regarding the effects of the adoption of the Malaysian code on corporate governance and its influence on company performance in Malaysia. In addressing this issue and to better understand what has happened in the aftermath of that crisis mentioned above, this paper provides empirical evidence concerning the board of directors' characteristics effects on firm performance for the 341 Malaysian listed companies throughout the period ranging from 2003 to 2013.

The remainder of this paper is structured as follows: The next section provides the review of the previous literatures on the firm performance factors. The third section considers the hypotheses development for this study. The fourth section presents the methodology used for collecting and analysing data. The fifth section indicates the results of the study. The final section concludes the paper.

2. LITERATURE REVIEW

Although Malaysia has introduced many reforms to promote corporate governance, their effects on firm performance are still unclear. In Malaysia, an early study conducted by Haniffa and Hudaib (2006), board size and CEO duality showed a significant and positive relationship with ROA among 347 Malaysian non-financial listed companies, from 1996 to 2000. Ponnu (2008), however, who used a sample of 100 Malaysian non-financial listed companies from 1999 and 2005, concluded that CEO duality and the proportion of independent directors had no significant relationship with ROA. A study conducted by Shakir (2008) on a sample of 81 property companies between 1999 and 2005 showed that the relationship between board size and firm performance was significant but negative, while the percentage of independent directors showed a significant and positive relationship with firm performance. Zainal Abidin (2009) selected 75 Malaysian non-financial listed companies, and found that the influence of board size on firm performance

was positive, while CEO duality had no apparent influence on performance.

Ponnu and Karthigeyan (2010) investigated 115 listed companies in 2006 and found no significant influence of independent directors, board size and board meetings on ROA. However, Ramdani and Witteloostuijn (2010) revealed in their study that, the proportion of independent directors and CEO duality had a significant and positive influence on ROA. Ibrahim and Abdul Samad (2011), who used a sample of 290 non-financial companies, between 1999 and 2005, found that board size, independent director and CEO duality showed a significant positive influence on ROA. However, in contrast, based on data from 30 Malaysian listed companies, Chaghadari (2011) concluded that a significant but negative relationship existed between CEO duality and ROA, and independent directors and board size showed no significant relationship with ROA.

Marn and Romuald (2012) analysed the data of 20 Malaysian listed companies from 2006 to 2010 and discovered that board size had a strong significant influence on EPS. However, the proportion of independent directors and CEO duality showed no significant influence on EPS. Shukeri, Shin and Shaari (2012) used a sample of 300 Malaysian listed companies and found that CEO duality showed no significant relationship with firm performance, while the relationship between board size and firm performance was significant and positive and, conversely, independent directors showed a significant but negative relationship with firm performance. Another study conducted by Kassim, Ishak and Abdul Manaf (2012) explored the data of listed companies from 2007 to 2009 and found a positive and significant relationship between independent directors and firm performance. Fooladi and Shukor (2012), who analysed the data of 400 listed companies, reported that independent directors, CEO duality and board size showed no significant relationship with ROA.

However, Noor and Fadzil (2013) collected data from 162 non-financial public listed companies for the years 2006 and 2008 and found that board size, percentage of independent directors and board meeting frequency showed a significant and positive direct relationship with ROA. On the other hand, Taghizadeh and Saremi (2013) examined 150 Malaysian listed companies in the year 2008 and found that board meeting and a high percentage of independent directors negatively influenced ROA. Rad et al. (2013), who tested 96 Malaysian listed companies between 2006 and 2010, discovered that the influence of CEO duality on firm performance was significant but negative.

By reviewing large numbers of previous studies that conducted in Malaysia, their results on the influence of board of directors' characteristics on firm performance are inconsistent. Some studies showed positive influences while others demonstrated negative influences.

3. HYPOTHESES DEVELOPMENT

Agency theory suggests that the board of directors is a significant component of corporate governance which companies should consider. An effective board of directors is considered to be the main internal governance mechanism to monitor

managers so as to ensure they are running their companies effectively to achieve a good performance (Fama & Jensen, 1983). Thus, this paper goes deeply to investigate the influence of the board of directors' characteristics on enhancing firm performance. Therefore, the hypotheses of this paper were developed based on the board of directors' characteristics, which involve CEO duality, independent directors, board size and board meeting.

3.1. CEO Duality

The CEO is the person who holds the highest ranking executive position in a firm, and plays the focal role in any firm. CEO duality is a significant tool of board structure, which reflects the position of CEO and chairman of the board (Schmid & Zimmermann, 2008). The literature on corporate governance provides different views on the desirability of CEO duality based on the agency and stewardship theories. Agency theory recommends that the positions of CEO and chairman be separated and held by two different individuals to avoid the concentration of power in one hand. If the CEO also holds the position of chairman, the board will be controlled by one person and cannot effectively perform its roles, which include monitoring management, increasing performance and protecting the interests of shareholders (Arosa, Iturralde & Maseda, 2012). In addition, separating the two roles is an efficient way to ensure the elimination of possible errors and of conflicts of interest that may occur when the two roles are combined (Banks, 2004). However, the stewardship theory argues that when the two roles are separated, the power is divided between two different people, which may lead to competition and conflict between them (Condit & Hess, 2003). The power should be concentrated in one hand to help the manager make important investment decisions to increase the firm's performance.

3.2. Independent Directors

Independent directors are individuals who are elected by shareholders, not members of the company management (Stein & Plaza, 2011). The clear separation of independent directors from any direct or indirect association with the firm's management is the key to being a reliable governing tool in their judgments and providing equal standing for the different levels of shareholders (Beasley, 1996). Fama and Jensen (1983) suggested that an effective board should contain an adequate number of independent directors for the purposes of monitoring managers and ensuring that they are running their firms effectively to achieve the highest possible performance and to protect the interests of shareholders, especially the minority of shareholders (Dalton et al., 1998).

3.3. Board Size

Board size refers to the number of directors who are presiding over the board. However, the real number of directors needed for the board to be effective and give a better performance is a matter of debate. When the board is extremely large, agency problems

may increase inside the board and the board becomes less involved in management procedures (Hermalin & Weisbach, 2003). A small board and one not beholden to the CEO can be more active in increasing performance, because communication is much easier than when a large board is involved (Kiel & Nicholson, 2003). In contrast, from the agency theory perspective, having more directors on the board can make it more difficult for the CEO to control the board; therefore, the board becomes more effective in monitoring the CEO as well as improving the firm's performance (Fama & Jensen, 1983).

3.4. Board Meeting

Board meeting refers to the number of meetings held by the board within a year. The directors of companies with more frequent meetings may become more involved in management processes, which could lead the CEO to feel controlled by the board. Therefore, directors should not request for a meeting to be held unless there is a significant issue to be discussed or resolved (Vafeas, 1999). On the other hand, some commentators believe that increasing the number of meetings can be a means to enhance performance. An empirical study conducted by Noor and Fadzil (2013) found that having more meetings played a significant role in increasing company performance.

Based on the review, two main hypotheses to examine the influence of board characteristics on the performance of companies listed on Bursa Malaysia are designed as follow:

H₁: the first main hypothesis is to examine whether, or not, board characteristics have an influence on return on assets among Malaysian listed companies.

H₂: the second main hypothesis is to examine whether, or not, board characteristics have an influence on earnings per share among Malaysian listed companies.

4. METHODOLOGY

4.1. Data Collection

The study relied entirely on secondary panel data obtained from two different sources for collecting corporate governance and firm performance data for 341 Malaysian listed companies. The data required for corporate governance has been manually collected from the companies' annual reports. CEO duality takes the value of 0 or 1 depending on the position of CEO and chairman. The value 0 is given when the two positions were separated, while the value 1 is given when not separated. The Independent director is the number of independent directors sitting on the board. Board size is the number of directors sitting on the board. Finally, board meeting is the total number of board meetings held each year.

This is rather spoken; the data on firm performance measured by ROA and EPS have been collected from Bloomberg databases. All relevant data were collected from 2003 to 2013. The year 2003 was selected because it is the year after the Malaysian code was issued, while the year 2013 is the year after this code was revised.

4.2. Population and Sampling

The population of the paper comprised of all companies listed on 31 December 2013 under the Bursa Malaysia main market. Purposive sampling was used and 341 out of total 531 companies were selected on the basis of availability of their annual reports throughout the period of the study. Companies have been selected from all sectors, except the financial sector because of the differences in regulatory requirements, and the REITS and Hotel sectors due to the fact that such two sectors had very few companies and were not considered to be significant.

4.3. Data Analysis

The collected secondary data analysed in this paper using panel data regression model to form hypotheses testing on the influence of the board of directors' characteristics on firm performance. The regression test was performed using the STATA13 software.

In this study, different statistical techniques were applied to help choose the appropriate model among pooled-OLS, fixed effect model and random effect model for each hypothesis. In panel data analysis, it is unlikely that the major assumptions underlying the pooled OLS model (which include normality, linearity, homoscedasticity, and autocorrelation) will be met. As a first step, the F-test (Chow test) and the Breusch Pagan / Langrange Multiple (BP-LM) test were used to decide between pooled OLS regression and the alternative fixed and random effects regression, respectively. The null hypothesis in both the F test (Chow test) and the BP-LM test is that there is no significant difference across firms; this would result in acceptance of the pooled OLS model. However, if the tests indicate that there is a significant difference across firms, the alternative hypothesis (fixed and random effects) is accepted. The results in Table 1, based on the two tests F test and BP-LM, show that the pooled OLS regression model is inappropriate and the alternative fixed and random effects model are preferable at this stage.

Table 1. The decision between pooled OLS, random and fixed effects

Statistical used		Pooled - OLS vs FEM		Pooled - OLS vs REM		Decision OLS, FEM/REM
		X ²	P-value	X ²	P-value	
F-test	Hypothesis 1	2.93	0.0000	-	-	FEM
	Hypothesis 2	5.36	0.0000	-	-	FEM
BP-LM test	Hypothesis 1	-	-	396.55	0.0000	REM
	Hypothesis 2	-	-	1463.88	0.0000	REM

Note: Ordinary least square (OLS), fixed effect model (FEM) and random effect model (REM). The X² represents the test of difference across firms with p-value at 5% significant level.

The Hausman specification test, on the other hand, was used to decide between the two estimation methods (fixed effects and random effects) for hypothesis testing in the next section. The null hypothesis for the Hausman specification test is that there is no correlation between unique errors and the independent variables used in the regression model, thereby suggesting exogeneity. If this is the case, the random effects regression model can be used. However, if there is a correlation between the unique errors and the independent

variables, the fixed effects model should be used, instead. The results of Hausman test in Table 2 report that the null hypothesis of no correlation between the unique errors and the specific board characteristics measurements as independent variables is rejected at 5% significant level. In this respect, the random effect regression model is rejected and the fixed effect regression model is appropriate to test as a method of estimation in the two hypotheses.

Table 2. Hausman test results (Fixed vs. Random)

	Variables	FEM		REM		Hausman test		Decision FEM / REM
		Coef.	p-value	Coef.	P-value	X ²	p-value	
Hypothesis 1	C	5.205561	0.079	1.835624	0.402	14.39	0.0061	FEM
	CEO duality	-8.055419	0.003	-9326342	0.574			
	ID	2.473784	0.000	2.139427	0.000			
	BS	-.5154199	0.159	-.1528579	0.575			
Hypothesis 2	BM	-.8614507	0.001	-.6527644	0.002	12.69	0.0129	FEM
	C	.2024373	0.000	.0975484	0.041			
	CEO duality	-.0520497	0.311	-.0245747	0.509			
	ID	.0186193	0.091	.0283645	0.004			
	BS	-.0031725	0.648	-.004699	0.417			
BM	-.0146853	0.003	-.0123532	0.004				

Note: Constant (C), independent directors (ID), board size (BS), board meeting (BM), women directors (WD), audit committee (AC). Fixed effect model (FEM), random effect model (REM), and coefficients (Coef.). The X² represents the test of difference among fixed and random effects estimates with p-value at 5% significant level.

4.4. Model Specification

The aim of this section is to show the empirical model used in this study. The dependent variable is the firm performance measured by return on assets

(ROA) and earnings per share (EPS). The four independent variables comprised CEO duality, independent directors (ID), board size (BS) and board meeting (BM).

The empirical model is as follows:

$$y_{it} = \beta_0 + \beta_1 X_{it} + \beta_2 X_{it} + \dots + \beta_k + \varepsilon_{it} \quad (1)$$

Where:

- y_{it} = dependent variable,
- X_{it} represents explanatory variable,
- $i = 1, \dots, N$ which denotes the cross sectional dimension (companies),
- $t = 1, \dots, T$ which denotes the time series dimension (time periods),
- β_0 represents the constant term,
- β_1 is the coefficient of the explanatory variables,

- ε_{it} represents the error term.

5. EMPIRICAL RESULTS AND DISCUSSION

Hypotheses 1 and 2 were tested to examine whether or not the board characteristics influences the performance of firms listed on the Malaysian market. The results presented in Table 3 are based on the fixed effect method (FEM) at 5% level.

Table 3. Regression results FEM

Variables	ROA			EPS		
	Coef.	t-Statistic	P-value	Coef.	t-Statistic	P-value
C	5.205561	1.76	0.079	0.2024373	3.60	0.000
CEO duality	-8.055419	-2.98	0.003	-0.0520497	-1.01	0.311
ID	2.473784	4.26	0.000	0.0186193	1.69	0.091
BS	-0.5154199	-1.41	0.159	-0.0031725	-0.46	0.648
BM	-0.8614507	-3.35	0.001	-0.0146853	-3.01	0.003
R-square	1.11%			0.38%		

Note: Constant (C), independent directors (ID), board size (BS), board meeting (BM).
Return on assets (ROA), earnings per share (EPS), and coefficients (Coef.).

The output of the fixed effect model when the return on assets is considered as a proxy for firms' performance, (hypothesis 1), indicated that, by looking at (R^2), 1.11% of the return on assets was contributed by board characteristics measured by four sub-variables (CEO duality, independent director, board size and board meeting). Board size was found to be negatively related to return on assets but statistically insignificant ($p = 0.159 > 0.05$). The insignificant result found in this study supported the findings of Ponnu and Karthigeyan (2010) who found no significant relationship between the board size and return on assets. In contrast, this result completely contradicts the findings of Javed et al. (2013) who found positive influences between the two variables, and the results of Garba and Abubakar (2014) who, in turn, found a significant and negative influence between the two variables. The insignificant result could be in line with the view of Conger and Lawler (2009) who claimed that whether or not the board is effective is not a question of size, but, rather, the extent to which the board members operate as a single unit.

However, CEO duality and board meeting were found to be statistically significant (p respectively = 0.003 and 0.001 < 0.05) and negatively related to the return on assets. The result of CEO duality contradicts the findings of Ponnu (2008) who found no influence between the two variables, and the findings of Ramdani and Witteloostuijn (2010) who found a positive influence. The negative result of this study did not provide empirical support to the Malaysian code on corporate governance recommendations, which aligned with the assumptions of agency theory of the role separation between the CEO and the Chairman. Therefore, the negative correlation between the two variables may suggest that the internal model of corporate governance is inappropriate in the Malaysian business environment as CEOs may pursue riskier strategies to maximise their own interests, consequently leading to lower accounting performance results (Haniffa & Hudaib, 2006). On the other hand, contradicted with previous findings of Noor and Fadzil (2013) who found positive

relationships, and the findings of Ponnu and Karthigeyan (2010) who found no influence between the two variables, this study has showed that board meetings influence the performance measured by the return on assets of Malaysia listed companies. A possible explanation may not align with the view that when directors hold more meetings, their performance becomes more effective. This may be because decisions made by the board could possibly be influenced by the number of board meetings (Vafeas, 1999). Therefore, directors should not request for a meeting to be held unless there is a significant issue related to return on assets to be discussed or resolved.

The only board characteristics variable that showed a significant ($p = 0.000 < 0.05$) and positive influence on return on assets was the independent directors, which means that this variable made a significant and positive unique contribution to the prediction of return on assets. This result supported the findings of Ramdani and Witteloostuijn (2010), and Javed et al. (2013), who all found positive influences between the two variables. Meanwhile, the same result contradicts the findings of Ponnu (2008) who found no influence at all between the two variables. On the other hand, the result of this study does not support the findings of Taghizadeh and Saremi (2013), or Garba and Abubakar (2014), all of whom found negative influences between the two variables. The result found between the independent directors and return on assets supported the assumptions of agency theory and contradicted the assumptions of stewardship theory, which believes that having more inside directors sitting on the board effectively improves the firms' performance rather than the independent directors. A possible explanation of the positive result is that the independent directors may not have a relationship with the firm, which allowed them to independently monitor the CEO of the firm. At the same time, the independent directors may be strongly involved in the general meetings.

Nonetheless, when earnings per share (EPS) is used as a measure of a firm's performance (hypothesis 2), the way of the results takes a

different direction. The output of the fixed effect method showed that, by looking at (R^2), 0.38% of the earnings per share was contributed by the CEO duality, independent director, board size and board meeting. The results showed that the independent director has a positive but insignificant ($p = 0.091 > 0.05$) impact on the firm's performance measured by earnings per share. While this result contradicted the findings of Adebayo, Olusola and Abiodun (2013) who found positive and significant effects between the two variables, it supported the findings of Marn and Romuald (2012), who found no significant relationship between the two.

CEO duality and board size, on the other hand, have a negative and also statistically insignificant ($p =$ respectively 0.311 and 0.648 > 0.05) effect on earnings per share. The insignificant results found mean that all the two variables did not make a uniquely significant contribution to the prediction of earnings per share. The insignificant result of this study did not provide empirical support to the Malaysian code on corporate governance recommendations to separate the two roles between the CEO and the Chairman. This result supports the findings of Marn and Romuald (2012) who found no influence between the two variables. However, Adebayo et al. (2013) found a significant and negative relationship between them, while Amran and Ahmad (2011) found a significant and positive effect between the variables. The reason of the insignificant relationship between the two variables could perhaps be due to the lack of consensus on the recommendation for the separation the two positions (Abdullah, 2006). However, the result between board size and earnings per share contradicted the findings of Marn and Romuald (2012) who found a positive and significant relationship between the two variables, and Adebayo et al. (2013) who found a statistically negative relationship between them.

However, board meetings were found to be statistically significant ($p=0.003<0.05$) and negatively related to the firm's performance measured by earnings per share. There are very few studies that address the relationship between the two variables. A possible explanation of this result may not support the view of Conger et al. (1998) who concluded that when directors hold more meetings, their performance becomes more effective.

CONCLUSION

This study is designed to investigate the influence of the board's characteristics on firms' performance. Board's characteristics are measured by CEO duality, number of independent directors, board size and frequency of board meetings while the firms' performance measured by return on assets and earnings per share. The data were collected from annual reports of 341 Malaysian companies listed on Bursa Malaysia throughout the period from 2003 to 2013. Two main hypotheses were tested using Panel data analysis. The results of panel data regression found to be generally mixed. To date, there is a lack of clear evidence regarding the effects of the adoption of the Malaysian code on corporate governance and its influence on company performance in Malaysia. In contradiction to what might be expected following the assumptions of agency theory, the regression results indicating, in most cases, negative and statistically significant influences between the board's characteristics and firm's performance. In particular, CEO duality showed a significant and negative influence on return on assets, while board meeting showed a negative and statistically significant influence on both measurements of firm performance, namely return on assets and earnings per share.

Therefore, the results of this study will contribute to the on-going debate on the influence between the board's characteristics and firm performance. Malaysian firms are needed to consider the importance of the board's characteristics in order to enhance their performance. This study was unusual, compared to earlier studies, in that it used a very large data set drawn from a relatively long period of time. Data were collected from a large number of firms (341) beginning from year 2003, when the Malaysian code was issued and extending to year 2013. Many previous studies that were conducted in Malaysia investigated the relationship between the board's characteristics and firm performance only over a short period and among smaller samples. Because of the large sample size, the results of the panel data methodology performed in this study provide meaningful interpretations and can be generalised. The conclusion could be that the present listing requirements for board's characteristics might not be effective as expected in terms of improving future firms' performance.

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