

# CORPORATE GOVERNANCE AND FINANCIAL PERFORMANCE OF PUBLIC LISTED COMPANIES IN MALAYSIA

*Kwee Pheng Lim\**, *Hishammudin Ismail\*\**, *Uchena Cyril Eze\*\*\**

## Abstract

This study investigates a link between corporate governance and ownership structures on firm performance of 293 companies listed on the Main and Second Board of Bursa Malaysia from 2000-2006. A dynamic panel system generalized method of moment technique is applied to control the endogeneity effect. After controlling for size, gearing, industry and time, this study finds significant positive relationships between institutional and foreign shareholdings using both market and accounting performance measures. These results imply their positive roles in constraining any opportunistic behavior of management. Interestingly, role duality (positions of Chairman and CEO were the same person) was observed to be negatively related to both performance measures, thus supporting the recommendation by Malaysian Code of Corporate Governance (MCCG). However, contrary to agency theory and MCCG, firm performance decreases with the increase in proportion of independent directors in the board.

**Keywords:** Corporate Governance, Agency Theory, Stewardship Theory, Resource Dependency Theory

\* Corresponding author, Faculty of Business, Multimedia University, Jalan Ayer Keroh Lama, 75450 Melaka, Malaysia

Tel.: (606) 252-3302,

Fax: (606) 231-8869,

E-mail: [kpim@mmu.edu.my](mailto:kpim@mmu.edu.my)

\*\* Associate Professor, Faculty of Business, Multimedia University, Melaka, Malaysia

Tel.: (606) 252 3624

E-mail: [hisham@mmu.edu.my](mailto:hisham@mmu.edu.my)

\*\*\* Division of Business and Management, United International College, B414, 28, Jinfeng Road, Tangjiawan Zhuhai, Guangdong Guangdong Prov. China 519085

E-mail: [uchennaeze@uic.edu.hk](mailto:uchennaeze@uic.edu.hk)

## 1. Introduction

Corporate governance (CG) has received much attention lately because of a series of corporate scandals around the world such as Enron, WorldCom. This has resulted in capital flight from affected countries as investors lose confidence and trust in the firms that they invested in. It is believed that good CG enhances investor confidence (Claessens, Djankov & Xu, 2000b). In fact, a survey by McKinsey (2000) found that Asian investors are willing to pay premium averaging 20-25% for well governed companies. Therefore, to restore public confidence, not only current corporate legislature needs to be reviewed but also the way in which these businesses have been conducted in the affected countries. There must be greater transparency and accountability in both public and private sectors to ensure stability of market oriented economics. Around this time, governments of many countries around the world have undertaken various measures to improve the efficacy of the governance structures for this will not only attract

more foreign investments into the countries but also investors are willing to pay a premium for the price of shares (Coombes & Watson, 2000). Furthermore, effective CG also promotes efficient use of resources which will ultimately bring about benefits to the long term viability of the firms and the country at large (Gregory & Simms, 1999). In addition, there have been many academic studies (Vafeas & Theodorou, 1998; Weir, Laing & McKnight, 2002; amongst others) to determine the most effective governance structures.

This study makes a number of contributions to the literature. First, it adds to the empirical evidence on the relationship between board characteristics which include board sub committees and ownership structures (shareholdings by independent, executive and foreign shareholdings) and firm financial performance in a comprehensive model. Most existing studies have not examined these governance structure characteristics in a single study (Haniffa and Hudaib, 2006). Furthermore, the results would be more generalisable as the sample in this study includes

smaller firms unlike previous studies. Third, this study is undertaken using generalized method of moment (GMM) dynamic panel technique to control for endogeneity and therefore results are more robust. Fourth, in addition to agency and stewardship theories, resource dependency theory (RDT) is employed to explain the results obtained. Many empirical researches (Che Haat, Abdul Rahman and Mahenthiran, 2008; Abdul Wahab, How & Verhoeven, 2007 among others) predominantly discussed their findings based on both agency and stewardship theories. Recently, RDT has been applied broadly across the research domain to explain how companies reduce uncertainty and environmental interdependence (Hillman, Withers & Collins, 2009) by having resource rich directors on board. Instead of just focusing merely on agency theory, RDT can explain how directors who provide advice and counsel to the CEO and their close ties with the external environment can improve firm performance (Daily, Dalton & Cannella, 2003). Likewise Mangena, Tauringana and Chamisa (2012) in their study of severe political and economic crisis in Zimbabwe draws from RDT and political theory (Roe, 2003) to explain how CG mechanisms are structured in companies to ward off any threats that undermine their survival.

The objective of this paper is to examine the effect of the corporate governance structure on financial performance. Our analysis involves an examination of 293 companies listed on the main and second board of the KLSE (Previously Kuala Lumpur Stock Exchange. Now known as Bursa Malaysia.) from 2001 to 2006. Regression results indicate significant associations between accounting and market performance measures and board size, board composition, role duality, and institutional ownership, gearing and company size. Furthermore, the results showed a significant relationship between accounting performance measures and executive and independent directors' shareholdings. Contrasting results are observed for foreign ownership, negative for accounting return but positive for market return.

We begin our discussion with a brief review of CG development and ownership structures in Malaysia. In Section 3 we shall review the three theories that shall be employed in interpreting the results of this study and review the relevant literature on the impact of governance mechanisms on firm performance. It also sets out the hypotheses to be tested. Then we describe our methodology in Section 4, followed by analyses and the results in Section 5. The paper ends with a summary and concluding remarks as well as possible avenues for future research in Section 6.

## 2. Corporate Governance in Malaysia

### 2.1 Malaysia: A Government Led Model and institutional framework

The Malaysian government plays a prominent role in the development of the Malaysian corporate sector to promote industrialization and at the same time restructure society in terms of participation and ownership. The New Economic Policy (NEP) enacted in 1971 has entrenched government intervention in the corporate sector and since its implementation, business and politics became intertwined in Malaysia (Malaysia, 1971). According to Gomez and Jomo (1997), NEP has affected the way businesses were conducted which resulted in unequal access to opportunities. Therefore firm performance could be linked to the owner and how close their relationship or ties were with the political agents.

Table 1 provides the legislative framework for the Malaysian capital market before the financial crisis.

Following the 1997 economic crisis, one of the key weaknesses that surfaced was the overlapping authority of regulatory institutions governing the securities market and its ambiguous accountability. Therefore to address this issue, the Securities Commission Act of 1993 was amended to make the Securities Commission (SC) as the sole regulator for fundraising activities and for the corporate bond market. The Malaysian Capital Market Master Plan was established to further regulate the capital market a year later. The legal framework for corporate governance is based on common law. The legal framework governing companies is defined by the Companies Act of 1965 (CA); the Securities Industry Act of 1983, as amended; the Banking and Financial Act of 1989; the Securities Industry (Central Depositories) Act of 1991; the Securities Commission Act of 1993; the Futures Industry Act of 1993; and the Financial Reporting Act of 1997. Therefore, even before the implementation of MCCG in 2001, there was a certain degree of CG reforms in place such as the requirements to have independent directors presence in the board in 1987 and the setting up of audit committee with effect from 1994 (Khuo, 2003).

Even though, Malaysia has comprehensive laws relating to CG in terms of shareholder and creditor protection, shareholders were not active participants in the annual general meeting (Zhuang et al. 2000). In 2001, the Minority Shareholder Watchdog Group (MSWG) was established to promote shareholder activism. Subsequently, institutional investors are encouraged by the regulators to take the lead role as empirical evidences showed that they could bring about socially responsible changes in the firms that they invested

The Malaysian CG reforms cover the transparency and disclosure of timely information to shareholders and protection of minority interests.

Examples of specific reforms introduced by SC are that beneficial owners must be revealed in nominee accounts, the number of directorships a director can hold and disclosure on matters relating to interested

party transactions which directors have personal interests in, mergers and acquisitions that are provided in the amendments to CA 1965.

**Table 1.** Legislative Framework for the Malaysian Capital Market

1965	<i>The Companies Act (CA)</i>	<i>Governs all aspects of company law. Contains provisions on minimum levels of disclosure to the public, rights and obligations of the directors and shareholders.</i>
1973	The Securities Industries Act (SIA)	This Act was subsequently repealed and replaced by a similar Act in 1983. The Act provides more specific regulations on the securities industry and to protect investor interests. Amongst its provisions are the licensing of dealers, powers to curb excessive speculation, insider trading and market manipulation, and enhancement of supervision and control of the industry.
1987	Malaysian Code on Take-overs and Mergers	The code was enacted under the Companies Act to regulate corporate takeovers and mergers.
1989	Banking and Financial Institution Act (BAFIA)	The Act provides for the licensing and regulating of the activities of all types financial institutions including money broking services. The Bank Negara Malaysia (BNM) is the custodian of this Act.
1991	The Securities Industry (Central Depositories) Act (SICDA)	The Act governs the maintenance and operation of a central depository system.
1993	Securities Commission Act (SCA)	The Securities Commission (SC) was established as a regulatory body for the capital market.
1993	The Futures Industry Act (FIA)	Provides for the establishment of futures exchanges and regulation of the trading in futures contract.
1995	SCA	Amendments were made which marked the first move of the regulatory regime towards a disclosure based regime
1997	The Financial Reporting Act (FRA)	The Act was to bring the financial reporting in step with international standards and for effective enforcements. The Financial Reporting Foundation (FRF) and the Malaysian Accounting Standards Board (MASB) were established to set reporting and accounting standards.

Source :Khou, B.Y (2003). *Corporate Governance in Malaysia*. Asian Development Bank which was adapted from Securities Commission website.

## 2.2 Ownership structures

Concentration of ownership and control in most Malaysian companies tends to be invested by blockholders, which include the government, families and other institutions (Claessens et. al., 1999, Khatri et al., 2003, Lee, 2001, La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998). Further, the high degree of concentration was due to interlocking or pyramiding structure in which a holding company owned a minor but significant proportion of shares in a large number of companies (Lim, 1981).

Zhuang et al. (2000) found that in closely held firms, the major shareholders are either individual/family. Many of these firms were started by the founders of the family and even when the companies were publicly listed, they are still actively involved in their businesses (Redding, 1996). They may even hand over the businesses to the future generations as they have long term plans for the business such as the Genting and YTL (Yeoh Tiong Lay Group currently headed by Tan Sri Francis Yeoh.) Group. Such firms performed better because of high ownership concentration and close business

networks (Redding & Wong, 1986). They also found that majority of the Malaysian firms are family (42.6 percent) and state owned (34.8 percent) which confirmed with Claessens et al. (1999). But, in a later study on ownership structure in Malaysia by Tam and Tan (2007), it was shown that government has the highest ownership concentration, followed by trust fund firms, foreign firms and family controlled business

The ownership structure in Malaysian companies differs from that of the Anglo-American CG system where the owners are separated from control and control is delegated to managers. Therefore, the agency problem experienced in Malaysia is different

from dispersed ownership structure and the problem is between controlling shareholders and minority shareholders (Tam & Tan, 2007).

### 2.3 CG Milestones

In 1998, the Ministry of Finance commissioned the set up of a body known as the High Level Finance Committee (HLFC) (CG Guide: Bursa Malaysia.) on Corporate Governance to address any CG shortcomings after the Asian financial crisis in 1997. Subsequent CG reforms that took place after the 1997 crisis is provided in Table 2.

**Table 2.** CG Milestones

1998	Formation of High Level Finance Committee to conduct a detailed study on CG
1998	The MCCG practices in Malaysia.
1999	Directors and CEO were required to disclose their interests in PLCs
1999	PLCs were required to submit quarterly reports to public
2000	SCA was amended to make SC the sole regulator for fund raising activities.
2001	KLSE issued its revamped LR to include new sections on CG and disclosure requirements
2001	Minority Shareholders Watchdog Group (MSWG) was established to promote shareholder activism
2001	Directors are required to attend mandatory training
2001	The Audit Committee must have a member who has a finance background.
2001	The Financial Sector Master Plan was launched to chart the future direction of the financial system over the next 10 years
2002	The internal audit guidelines for PLCs was issued
2004	Best practices for corporate disclosures and whistle blowing provisions in securities laws
2005	Amendments to LR: new policy of enforcement for delays in issuance of financial statements
2007	New updates to MCCG with strengthening of audit committee
2010	Setting up of the Audit Oversight Board (AOB)
2011	Capital Market Master Plan 2 (CMP2)
2012	CG Blueprint issued by SC, followed by MCCG 2012

Taken from CG Blueprint 2011: <http://www.sc.com.my/main.asp?pageid=1087&menuid=&newsid=&linkid=&type=>

As can be seen from the table, there are two updates to MCCG 2001, one in 2007 and the other in 2012. These updates take into account changing market dynamics, international developments in the CG framework on how to enhance its effectiveness.

## 3. Prior Empirical Studies and Hypotheses Development

### 3.1 Theories

Agency theory has been used to explain the problem arising from the separation of ownership and control in much of the literature on corporate governance following the numerous corporate scandals, which happened globally (Berle & Means, 1932; Eisenhardt, 1989). In order to minimize these problems, various CG mechanisms have been suggested such as having

outside directors in the board structure and subcommittees consisting of majority independent directors (Vafeas, 2003). Many of the CG codes around the world (US, UK and Malaysia, among others) have advocated for the positions of Chairman and CEO to be held by different individuals (non-role duality) and the former should be independent so that there is a check and balance on the actions of the CEO. The Chairman is responsible for ensuring the board carries out its oversight duty well whilst the CEO helms the management of the company. Another researcher, Matsumura and Shin (2005) suggested top management be rewarded for good performance. The incentive solution was to tie the wealth of the executive to the wealth of the shareholders so that their interests are aligned. In many of the US companies, executives are given stock options as a

significant component of their compensation (Kim & Nofsinger, 2007).

Stewardship theory comes from the branch of sociology and psychology. Stewardship asserts a model of the human being in which individuals act to serve the collective interests of the firms. This is in contrast to economics based agency concepts of people as individualistic and self-serving (Davis, et al., 1997; Fox & Hamilton, 1994). Furthermore, it suggests that management will always put the interests of the principals above their personal interests because they strongly believe in cooperation than self-serving behaviour (Davis et al). The steward's interests are aligned with those of the investor and so the steward is less apt to engage in self-serving behaviours and actions that transfer wealth from the investor to the steward. Therefore, there is a lower need for monitoring and control mechanisms to check the opportunistic behaviour of managers. Boards should not be dominated by non-executive director as they lack the knowledge, time and resources to monitor management effectively (Donaldson & Davis, 1994). Another structure proposed by stewardship theorists include that CEO should chair's the board of directors because outside chairman may impede strategic decision making process due to lack of knowledge and expertise. In a stewardship environment, there is more emphasis placed on empowerment and structures that facilitate cooperative activities in a non-adversarial fashion (Brooks & Dunn, 2007).

Although the agency and stewardship theories have been widely used in research on board of directors (Dalton, Hitt, Certo, & Dalton, 2007; Johnson, Ellstrand, & Daily, 1996; Zahra & Pearce, 1989), earlier studies have used RDT in explaining how board gain resources through varying its board size as well as board composition. Pfeffer (1987) in his seminal paper found that firm's environmental needs impacted the board size as well as its composition. According to them, these directors brought about four benefits to organizations, namely, they provide advice and counsel; they have access to information about firms and its environment; they have preferential access to resources and they possess legitimacy. Earlier studies (Provan, 1980; Luoma & Goodstein, 1999, Johnson & Greening, 1999) supported their claims. In his study, Provan (1980) found that firms attracted powerful members of the community who have connections with the environment to their boards. Luoma and Goodstein (1999) found that firms in highly regulated industries have a higher proportion of stakeholder directors and these stakeholder directors are found to improve firms' corporate social performance (Johnson & Greening, 1999). More recent works (Mangena, Taurigana & Chamisa (2011); Claessens, Feijen & Laeven, 2008; Adams & Ferreira, 2007) supported the above arguments as well. In their study of board size and ownership concentration in an environment of

severe political and economic crisis, Mangena et al. (2011) concluded that firms tend to have larger boards (engaged directors with political connections) to ward off external threats of political environment as well as having lesser non executive directors. During such crisis, executive directors could better manage the firm

### 3.2 Corporate governance mechanisms

A review of prior empirical literature on the relationship between CG and ownership structures on firm performance showed mixed results.

Huther (1996) and Yermack (1996) found that the market perceived smaller boards more effective than larger boards. Yermack found a positive stock price reaction for firms announcing a reduction in board size and a negative stock price reaction to announcements on increase in board size. The logic for why this might be so deals with the free-rider problem. For a small board, each member may need to monitor the firm, as there are a few of them. However, members of larger boards may assume that there are others who are monitoring. Another reason is that it may be more difficult to reach a decision with larger boards (Lipton & Lorsch, 1992).

On the other hand, bigger boards not only bring in more skills, diversity and experience into the firms but also create added value in management of resources (Goodstein et al., 1994; Pearce & Zahra, 1992). Empirical evidences supporting the resource dependency theory found that "resource rich" directors have access to important and critical resources. Provan (1980) found that boards who have powerful members of community are able to acquire critical resources from the environment, thus impacting positively on firm performance. However, Holthausen and Larker (1993) failed to find a link between board size and financial performance. Since MCCG does not recommend any board size and prior studies produced mixed results, the following hypotheses are stated as follows:

$H_1$ : There is a significant relationship between board size and firm performance.

Proponents of agency theory believed that a board comprising a larger representation of independent directors will be more effective in monitoring management by checking on the opportunistic behaviour of the executive directors (Fama & Jensen, 1983). According to Farrell and Whidbee (2000), a board comprising members who are related to the CEO is probably less likely to fire the CEO for poor performance. Furthermore, the presence of truly independent directors in the board, audit, compensation, and nominating committees has been found to be more likely to monitor management's activities effectively by several academic studies (Byrd & Hickman, 1992; Daily & Dalton, 1992; Fama, 1980; Jensen, 1993), accounting

professional (AICPA<sup>1</sup>, 1992), government regulators such as US Securities and Exchange Commission, 1988, US Committee Of Sponsoring Organization of the Treadway Commission. Similarly, proponents of resource dependency theory provide evidence to support their claims that “resource rich” outside directors may by virtue of their contacts have access to critical resources (Pfeffer & Salancik, 1978; Johnson & Greening, 1999 among others).

However, empirical evidences on the role of independent directors were mixed. Some studies had not found such an association (Che Haat et al., 2008; Fosberg, 1989; Haniffa & Hudaib, 2006; Hermalin & Weisbach, 1991) whilst others had found a significant positive link (Daily & Dalton, 1994; Prevost et al., 2002). However, Koerniadi & Tourani-Rad (2012) conducted a similar study of NZ firms from 2004-2006 and found that board independence was negatively related to firm performance which was contrary to the findings of Prevost et al. Koerniadi concluded that this could possibly be due to the difference in time period of the studies; theirs was done a decade later when the number of independent directors was more. Their findings suggested that board independence may not generally be suitable for countries where managers were considered as active partners along with other stakeholders in companies. This was more consistent with stewardship theory than agency theory as the boards were seen to be collaborating with managers than being monitors. Recent findings (Chhaochharia & Grinstein 2007; Duchin et al., 2010) also concurred with theirs. A Korean study conducted during the governance reform movement in 1999 showed a weak link between outside directors and performance (Cho & Kim, 2007) which may be attributed to resistance of large shareholders to reform. Since MCCG recommends that companies should adopt a balanced board comprising at least one third independent directors to monitor management, the next hypothesis is as follows:

*H<sub>2</sub>*: There is a significant positive relationship between board composition and firm performance.

There are two views regarding the issue of separating the role of chairperson and that of the CEO. Proponents of agency theory argue that the chairperson has to be independent in order to check on the possibility of the over ambitious plans of the CEO (Argenti, 1976; Blackburn, 1994; Stiles & Taylor, 1993). The separation of the two roles is necessary to provide the essential checks and balances over management performance. This was because a person who held both positions of CEO and Chairman would most likely engage in choosing strategies that promote his own interest instead of the company's interests (Jensen & Meckling, 1976). Furthermore, the monitoring ability of the board of directors on management may be reduced. Yermack (1996) found that firms were valued lower when the same person

held both these positions. Agency theory therefore suggests that role duality reduce the monitoring effectiveness of the board over management and supports the separation of the role of chair and CEO.

On the other hand, those who favoured role duality use stewardship theory to support their case. They argued that managers will act in the best interests of the shareholders, as there was no inherent conflict between them as suggested in agency theory. Managers identified with the goals of the firm and strived to make sure those goals are achieved. Besides that, the benefits of role duality include faster implementation of decisions, which was due to lesser board interference and ability to focus on company objectives. Ultimately, this would lead to improvement in firm performance (Dahya, Lonie & Power, 1996).

Since MCCG recommends the separation of the two roles to ensure proper checks and balances on the top leadership of the companies, we hypothesize the following:

*H<sub>3</sub>*: There is a significant negative relationship between role duality and firm performance.

Empirical evidences on the relationship between the presence of audit committee and the financial performance have yielded conflicting results. Some found no significant association between this board committee and financial performance (Klein, 1998; Petra, 2002; Vafeas & Theodorou, 1998; Weir et al., 2002). Similarly, in the analysis of a sample of 412 publicly listed Hong Kong firms during 1995–1998, Chen et al. (2005) found little impact of audit committee on firm value. In contrast, Wild (1994) showed evidence that the market reacted favourably to earnings reports after an audit committee had been formed. Similarly in a study of UK companies using 1992 and 1996 data, Laing and Weir (1999) concluded that audit committee contributed to significant improvement in performance of firms than non-executive director representation or non duality.

The MCCG recommends the establishment of an independent audit committee with majority of independent directors to ensure proper checks and balances on top management. It is mandated by the LR to have such a committee in all public listed companies in 1994. The next hypothesis is as follows:

*H<sub>4</sub>*: There is a significant positive relationship between independent audit committee and firm performance.

Although not required by regulation, many corporations in US have instituted remuneration committees composed entirely of outside independent directors to give the appearance that a reasonable and objective process determines the compensation for top management, including the CEO. Cyert et al. (1997) found that the level of CEO compensation was inversely related to the level of stock ownership held by members of the remuneration committee. The result suggested that a remuneration committee might be an important element in the board of directors'

<sup>1</sup> American Institute of Certified Public Accountants

ability to monitor and control the actions and decisions of top management. Remuneration committees were more effective monitors as compared to non-duality or independent boards (Laing & Weir, 1999). Petra (2005) reviewed the case study on Enron Corp., Global Crossing Ltd and WorldCom and concluded that the presence of outside independent directors on the remuneration committees did not affect firm performance. In his earlier study, he too found no association between informativeness of earnings and remuneration committee (Petra, 2002). A study conducted by Yatim (2012) showed evidence that director remuneration was positively and significantly related to a firm's accounting performance (ROA). This indicated that such committee can strengthen boards by controlling the level of directors' remuneration.

The MCCG recommends the establishment of an independent remuneration committee to ensure that top management do not remunerate themselves excessively. The next hypothesis is as follows

*H<sub>5</sub>*: There is a significant positive relationship between independent remuneration committee and firm performance.

Here again, although not required by regulation, many corporations in US had instituted nominating committees, which were composed entirely of outside independent directors. Such nominating committees gave the appearance that the board of directors had little or no prior relationship with the CEO. Shivdasani and Yermack (1998) found evidence suggesting that directors selected by CEO were not likely to monitor the behaviour of management. Their findings also suggested that the market preferred the CEO not be involved in the appointment of new directors. This highlighted the need for boards of directors to maintain independent nominating committee. However, Klein (1998) and Petra (2002) found little evidence that such independent committee affected firm performance.

The MCCG recommends the establishment of an independent nominating committee to ensure that board members are selected based on personal merits. The next hypothesis is as follows

*H<sub>6</sub>*: There is a significant positive relationship between independent nominating committee and firm performance.

Many empirical studies in Malaysia revealed that the ownership structure of PLCs were highly concentrated and were held by a small number of individuals, families and state enterprises (Claessens et al., 2000a; Tam & Tan, 2007). These studies also noted the same observations as studies done elsewhere that is, relationship between performance and executive directors' shareholdings was not linear (Khatri et al. 2002; Tam & Tan, 2007). A study done in Malaysia showed consistent positive significant impact using three performance measures (Ngui et al., 2008). However, Haniffa and Hudaib (2006) found a negative impact using ROA while no relationship

using Tobin's Q. Because of the contrasting evidences on the relationship between directors' shareholdings and performance, the following hypothesis is as follows:

*H<sub>7</sub>*: There is a significant relationship between executive directors' shareholdings and firm performance.

Jensen (1993) espoused that outside independent directors should be encouraged to maintain ownership in their firms and this ownership should be significant in relation to the individual director's personal wealth so as to ensure that the director recognized that his/her decisions affected their own wealth as well as the wealth of the other shareholders. Similarly, Cotter, Shivdasani & Zenner (1997) concluded that independent outside directors enhance target shareholder gains from tender offers, and that boards with a majority of independent directors are more likely to use resistance strategies to enhance shareholder wealth. Proponents of agency theory argued that independent directors who owned shares might mitigate agency problems caused by dispersed ownership. Bhagat and Black (2000) found positive relationship between firm performance and independent directors' shareholdings.

On the other hand, Mc Connell and Serveas (1990) failed to find such an association between market based measure and independent directors' shareholdings. Several empirical evidences (Morck, 2004; Berle & Means, 1932) pointed out that such shareholdings had negative impact on firm performance as independent directors could have a misplaced sense of loyalty to dominant CEO instead of challenging their decisions. They might corroborate with management because of their non-independence. These arguments lead us to the next hypothesis

*H<sub>8</sub>*: There is a significant relationship between independent directors' shareholdings and firm performance.

Many empirical evidences demonstrated that institutional shareholders have the potential to exert positive influence on firm performance that also benefitted minority shareholders (Gillian & Starks, 2000; Li & Simerly, 1998). But in a dispersed ownership situation where there were no major blockholders, free rider problems may arise (Gugler, 2001). However, dominance of a large blockholder may also create problem by over exposing the firm to risks (Demsetz & Lehn, 1985). Yet other studies observed different investment strategies behaviour exhibited by institutional investors (Black 1992; Goyer, 2010; Maug, 1998) which contributed to contrasting results in firm performance.

Prior studies that recorded the effectiveness of the monitoring by institutional investors are many (Becht et al., 2009; Denis & Sarin, 1999; Gorton & Schmid, 2000; Del Guercio & Hawkins, 1999; Holderness & Sheehan, 1988; Joh, 2003; Leech & Leahy (1991); McConnell & Servaes, 1990; Morck et al., 2000; Park & Chung, 2007; Sarkar & Sarkar,

2000; Thomsen & Pedersen, 2000; Xu & Wang, 1999). In contrast, Woidtke 2002 noted that institutional investors may not be effective monitors as there was no single controlling shareholder to ensure that managers were doing their job. Other studies found no empirical relationship between institutional ownership and firm performance (Demsetz & Lehn, 1985; Demsetz & Villalonga, 2001; Duggal & Millar, 1999; Faccio & Lasfer, 2000; Karpoff et al., 1996; Lee, 2009; Murali & Welch, 1989; Smith, 1996; Weir et al 2002). Some observed that pressure insensitive institutional investors are more likely to discipline and vote against management rather than pressure sensitive ones (Abdul Wahab et al., 2008; Brickley et al., 1988; Cornett et al., 2007; Pound, 1988). They observed that large institutional shareholders corroborated with management when it benefitted them to do so which may result in high risk exposure and subsequently a decline in firm performance.

In Malaysia, many empirical evidences pointed to a high concentration of ownership among public listed companies (Abdul Samad, 2002; OECD, 1999). Similar mixed findings were found as other countries (Haniffa & Hudaib, 2006; Tam & Tan, 2007). Against this backdrop, the hypothesis is formulated as follows:

$H_0$ : There is a significant relationship between institutional shareholdings and firm performance.

Prior research found that foreign owners can mitigate agency problems as they can exert much influence on management to align their interests with investors (Hingorani et al., 1997; Jensen & Meckling, 1976). The results of Che Haat et al. (2008) supported that of D'Souza et al. (2001) in that foreign ownership brought about benefits such as higher managerial talent, access to advanced technology and entry into capital markets. Similarly, Weiss and Nikitin (2004) found that when foreigners became the major shareholders of publicly traded firms in the Czech Republic, these firms experienced improvements in performance. Other empirical studies which found that firms with higher share of foreign ownership performed better than their domestic counterparts were many (Ali Yrkko & Nyberg, 2005; Baek et al. 2004; Douma et al., 2006; Park & Chung, 2007; Reese & Weisbach, 2002; Sarkar & Sarkar, 2000; Suto, 2003; Tam & Tan, 2007). Yet there are studies that found no association between the relationship between foreign ownership and firm performance, which could be due to their short-term investment view (Lee, 2009). On the other hand, foreign shareholders might not be effective monitors because of their close involvement with management in running of businesses (Redding, 1996). Therefore, this leads us to the next hypothesis:

$H_{10}$ : There is a significant relationship between foreign shareholdings and firm performance.

### 3.3 Control variables (firm-specific characteristics)

#### 3.3.1 Firm Size

Conflicting results were obtained in prior studies; some observed that firm size was positively related to firm performance. Larger firms performed better due to risk aversion (Ghosh, 1998), more analysts following their performance and banks prefer to finance larger companies (Black, Jang & Kim, 2006; Lee, 2009), better assets utilization because of economies of scale and managerial knowledge (Himmelberg et al., 1999; Tam & Tan, 2007). On the other hand, smaller firms reported positive results because they had more growth opportunities (Anderson & Reeb, 2003; Kouwenberg, 2006), more adaptable to change which enhanced competitiveness (Hannan & Freeman, 1989). On the contrary, Cornett et al. (2007) failed to find such a link. However, Haniffa and Hudaib (2006) found mixed results using Tobin's Q and ROA. Kole (1995) examined the differences in data source used in several studies by Morck et al.(1998), Mc Connell and Servaes (1990) and Hermalin and Weisbach (1991) and concluded that differences in firm size accounted for the reported differences in those studies. Therefore, these evidences lead to the next hypothesis:

$H_{11}$ : There is a significant relationship between firm size and firm performance.

#### 3.3.2 Gearing

According to agency theory, external creditors may help to reduce agency costs by disciplining management if they engaged in non-optimal activities (Jensen, 1986; Stulz, 1990). Several prior empirical findings were consistent with the implications of agency theory; debt financing were used as a CG tool to constrain opportunistic behaviour of management (Chen & Lee, 2008; Hurdle, 1974; Johnson & Mitton, 2003; Suto, 2003). Managers whose firms were financed mainly by external debts would engage in wealth generating activities to service the debts faster (Grossman & Hart, 1982) and thereby reduced cost of debts (John & Senbet, 1998; Kouwenberg, 2006).

On the other hand, results of some empirical studies yielded negative results (Chang & Abu Mansor, 2005; Claessens et al., 2000b; Downen, 1995; McConnell & Servaes, 1995, Short & Keasey, 1999; Suto, 2003; Tam & Tan, 2007; Weir et al., 2002). Some of the reasons uncovered were managers cum shareholders may be involved in risky projects to the detriment of other stakeholders (Stiglitz & Weiss, 1981). They found that not only debt financing is an ineffective CG mechanism to control management but resulted in poorer performance.

It was found that many Malaysian firms relied on external debt to finance its operations and had established close relationships with their bankers due



to political patronage (Gomez & Jomo, 1997; Suto, 2003). As such, debt was not an efficient governance tool in Malaysia. Furthermore, Tam and Tan (2007) supported the argument regarding the inability of the financial market to discipline poor performance firms due to excessive political and business relationship building. Chang and Abu Mansor (2005) also concurred with Tam and Tan. However, contrasting results were discovered by Haniffa and Hudaib (2006) using two types of performance proxies; negative significant association for the accounting measure but positively related for market measure. As previous studies have uncovered contrasting results, the hypothesis is as follows:

$H_{12}$ : There is a significant relationship between gearing and firm performance.

#### 4. Research Methods

##### 4.1 Sample selection

The sample in this study consists of non-financial, non-unit trusts companies listed on the main board, and second board of Bursa Malaysia (Bursa) from financial year ended 2001 to 2006. The reason for excluding financial and unit trusts companies from the sample is due to differences in the regulatory requirement in their reporting as in the studies done by Nazrul, Rubi and Hudson (2008) and Haniffa and Hudaib (2006). Only those companies which are in operation throughout this period are selected for this study.

The screening process finally yielded a sample of 293 companies with a panel sample of 1,758 observations across a six years period after excluding delisted companies over the sample period. This panel is balanced as all data are available for all the 293 companies throughout this period.

##### 4.2 Measures of firm performance and other independent variables

As for firm performance measures, there is no agreement among researchers as to which proxy is the best (Cochran & Wood, 1984). Each proxy has its own pros and cons. In this study, two measures are used market (Tobin Q) and accounting based returns (return on asset, ROA). Cochran and Wood went on to say that it is prudent to use a few measures to capture the various aspects of financial performance. Industry sector may affect firm performance due to differences in ownership structures and their objectives as shown in prior studies (Black, Jang & Kim, 2006; Lee, 2009; Tam & Tan, 2007).

There are ten independent variables, two dependent variables and two control variables. The ten independent variables are broken down into two types of structure namely corporate governance

structures (board characteristics) and ownership structures (shareholdings by executive directors, independent directors, institutions and foreigners). Similar breakdown were found in prior empirical research (Anderson & Reeb, 2003; Haniffa & Hudaib, 2006; Petra, 2002).

Data on CG variables, ownership shareholdings and accounting performance measure (ROA) were retrieved from the Bursa Malaysia's website (year 2001 onwards). Tobin's Q data was extracted from Bloomberg and DataStream databases. Table 3 provides a summary of the operationalisation of the variables.

##### 4.3 Econometric estimation

In most prior studies, the standard approach employed in examining the relationship between performance and corporate governance variables is the ordinary least squares (OLS) model. However, OLS models ignore the panel structure of the data by treating data as cross-sectional (Gujarati and Porter, 2009; Kohler and Kreuter, 2009; Roodman, 2009). Therefore, they violate the underlying OLS assumption that all observations are independent of each other. We carefully address potential endogeneity concerns by using a system generalized method of moments (GMM) approach developed by Arellano and Bond (1991), Arellano and Bover (1995) and Blundell and Bond (1998). The system GMM estimation is appropriate for analysis of data involving few time periods and a large number of companies. This method is commonly used in empirical analyses involving panel data because it is robust to panel specific autocorrelation and heteroscedasticity (Capezio, Shields and O'Donnell, 2010; Roodman, 2009). The degrees of freedom are increased and collinearity among the explanatory variables is reduced and the efficiency of economic estimate is improved. It achieves this using lagged differences and lagged levels of instruments. In order to obtain a consistent estimator, the validity of the instruments must be tested. The Sargan test and Arellano-Bond second order autocorrelation test (AR2) are conducted to assess the reliability of the estimates as well as to ensure no methodological problems exist. The Sargan test of over-identifying restrictions test the null hypothesis that instruments are not correlated with error term and thus tests the validity of the instruments. The AR2 tests the null hypothesis that there is no second order serial correlation in the disturbance term (Roodman, 2009). If the two hypotheses are not rejected ( $p > 0.05$ ), it implies that the system GMM approach is an appropriate method of analysis.

**Table 3.** Operationalisation of Variables

<i>Variables</i>	<i>Acronym</i>	<i>Operationalisation</i>
<b>Dependent variables</b>		
Tobin's Q	Tobin Q	Ratio of the market value of a firm to the replacement cost of firm's assets
Return on asset	(ROA)	Earnings after tax divided by total assets
<b>Independent variables</b>		
<u>CG variables</u>		
Board size	BSIZE	Total number directors in the board
Board composition	BRDC	% of independent directors in the board
Role duality of Chairman/CEO Positions	DUAL	Dichotomous, 1 if role duality and 0 if no role duality
Audit Committee	AUDC	Dichotomous, 1 with audit committee and 0 if no audit committee
Nominating Committee	NOMC	Dichotomous, 1 with nominating committee and 0 if no nominating committee
Remuneration Committee	REMC	Dichotomous, 1 with remuneration committee and 0 if no remuneration committee
<u>Ownership variables</u>		
% of executive directors' shareholdings	MOWN	% of shareholdings held by executive directors'
% of institutional shareholdings	IOWN	% of shareholdings held by institutions
% of foreign shareholdings	FOWN	% of shareholdings held by foreigners
<u>Control variables</u>		
Firm size	LNTA	Natural logarithm of total assets
Gearing	GEAR	Total debt to total assets
<u>Moderating variables</u>		
Industry based on Bursa Malaysia Classification	CP IP CM PH PT TS	Consumer Product Industrial Product Construction & Mining Property & Hotel Plantation & Technology Trading & Services
Year		2001-2006

The following two models based on agency, stewardship and resource dependency theories as well as prior research discussed in section 3. The models are estimated with inclusion of all dependent and independent variables and control variables. These

comprehensive models will therefore provide better insight into the effect of these structures on the firm performance. They are namely:

**Model 1:**

$$ROA_{it} = \alpha_0 + \beta_1(BSIZE)_{it} + \beta_2(BRDC)_{it} + \beta_3(DUAL)_{it} + \beta_4(AUDC)_{it} + \beta_5(REMC)_{it} + \beta_6(NOMC)_{it} + \beta_7(MOWM)_{it} + \beta_8(OOWM)_{it} + \beta_9(IOWM)_{it} + \beta_{10}(FOWN)_{it} + \beta_{11}(LNNTA)_{it} + \beta_{12}(GEAR)_{it} + \text{INDUSTRY DUMMIES} + \text{YEAR DUMMIES} + \varepsilon$$

**Model 2:**

$$\text{Tobin } Q_{it} = \alpha_0 + \beta_1(BSIZE)_{it} + \beta_2(BRDC)_{it} + \beta_3(DUAL)_{it} + \beta_4(AUDC)_{it} + \beta_5(REMC)_{it} + \beta_6(NOMC)_{it} + \beta_7(MOWN)_{it} + \beta_8(OOWN)_{it} + \beta_9(IOWN)_{it} + \beta_{10}(FOWN)_{it} + \beta_{11}(LNNTA)_{it} + \beta_{12}(GEAR)_{it} + \text{INDUSTRY DUMMIES} + \text{YEAR DUMMIES} + \varepsilon$$

Where

$\alpha_0$	Intercept
Tobin Q	Tobin's Q ; proxy for market return
ROA	Return on assets; proxy for accounting return
BSIZE	Board size.
BRDC	Board composition; Percentage of independent directors in the board.
DUAL	Duality; Role duality of 1 if chairperson of the board is also the chief executive officer. Otherwise 0
AUDC	Audit committee; Dichotomous 1 with audit committee and 0 if no audit committee
REMC	Remuneration committee
NOMC	Nominating committee
MOWN	Percentage of shares held by executive directors
OOWN	Percentage of shares held by outside independent directors
IOWN	Percentage of shares held by local institutions
FOWN	Percentage of shares held by foreign institutions
LNNTA	Natural logarithm of total assets
GEAR	Debt ratio defined as total debt to total asset
$\beta_1$ to $\beta_{12}$	Coefficient measuring relationship strength
$\varepsilon$	Error term

INDUSTRY base on Consumer products, equals 1 if true, otherwise 0  
 Bursa classifications Industrial products, equals 1 if true, otherwise 0  
     Property & hotel, equals 1 if true, otherwise 0  
     Plantation & Technology, equals 1 if true, otherwise 0  
     Trading/services, equals 1 if true, otherwise 0  
     Control group is Construction & mining

YEAR DUMMIES If 2001, equals one if true, otherwise 0  
 If 2002, equals one if true, otherwise 0  
 If 2003, equals one if true, otherwise 0  
 If 2004, equals one if true, otherwise 0  
 If 2005, equals one if true, otherwise 0  
 If 2006, equals one if true, otherwise 0

**5. Results**

**5.1 Descriptive Statistics**

Table 4 presents a breakdown of the sample data by industry sector and by board. The sample consists of 293 companies, that is made up of 239 companies (81.6%) in Main Board and 54 (18.4%) companies in the Second Board. It comprises six industrial sectors; the highest representation is 25.9% from the Industrial

Product followed by 23.5% from Trading & Services, 15.4 % from Consumer Product sector, 15% from Properties & Hotels sector, 12.3% from Plantation & Technology sector and 7.9 % from Construction & Mining sector.

Table 5 presents the descriptive statistics of the means for the performance, board and ownership structures and control variables from 2001-2006 and for each year.

**Table 4.** Sample Data by Industry Sector and by Board

Industry sector	Main Board		Second Board		Total	
	No	%	No	%	No	%
Consumer product (CP)	35	14.6	10	18.5	45	15.4
Industrial Product (IP)	52	21.8	24	44.4	76	25.9
Construction & Mining (CM)	22	9.2	1	1.9	23	7.9
Properties & Hotels (PH)	40	16.7	4	7.4	44	15.0
Plantation & Technology (PT)	31	13.0	5	9.3	36	12.3
Trading & Services (TS)	59	24.7	10	18.5	69	23.5
Total	239	100	54	100	293	100

Source: Analysis of the Secondary Data

**Table 5.** Descriptive statistics (means) for dependent and independent variables for combined sector

<i>Variables</i>	2001-2006	2001	2002	2003	2004	2005	2006
<i>Performance measures</i>							
ROA	-0.01	-0.031	-0.046	0.002	0.004	0.009	-0.002
TOBINQ	1.084	1.102	1.091	1.091	1.111	1.022	1.090
<i>Board and ownership structures</i>							
BFSIZE	7.633	7.669	7.703	7.720	7.560	7.608	7.539
BRDC	40.712	37.641	39.768	39.557	42.145	42.154	43.015
DUAL	0.15	0.174	0.143	0.143	0.143	0.147	0.147
AUDC	1	1.000	1.000	1.000	1.000	1.000	1.000
REMC	0.807	0.454	0.795	0.881	0.891	0.908	0.911
NOMC	0.805	0.457	0.795	0.877	0.891	0.904	0.908
MOWN	5.509	5.321	5.256	5.636	5.745	5.705	5.390
OOWN	0.182	0.192	0.175	0.161	0.208	0.178	0.180
IOWN	53.066	52.583	53.148	53.320	53.505	53.491	52.351
FOWN	9.8	9.327	8.946	9.205	9.682	10.138	11.505
<i>Control variables</i>							
LNTA	8.699	8.651	8.664	8.703	8.718	8.727	8.733
GEAR	0.549	0.586	0.757	0.510	0.469	0.484	0.491

ROA and Tobin's Q are -1% and 1.084 respectively. The yearly data also show that the means of ROA rebound slowly and slightly from 0.2% in 2003 to 0.9% in 2005 before it dipped again to -0.2% in 2006. Similar trends were observed for the yearly means of Tobin's Q throughout this period of study.

It also illustrates that, on average, board size (BFSIZE) in both periods is approximately eight members, which is consistent with previous studies (Lipton & Lorsch, 1992; Haniffa & Hudaib, 2006). The yearly data also show that board size is, on average, eight.

The proportion of independent directors in the board is 41%. It seems that most firms comply with the recommendation of having at least one-third board members comprising non executive directors. The proportion of independent directors had increased steadily to 43 % in 2006.

The mean % of firms having role duality (DUAL) is 15%, indicating that 85% of firms have

separated the role of chairman and CEO. The yearly data also indicated a downward trend in line with the recommendation of MCCG that the role of chairperson and CEO should be separated for better governance.

All the firms have audit committees (AUDC) starting from 2001 in compliance with the Code.

On average, the number of firms that formed remuneration committee (REMC) is 81%. The yearly data also show that the number of companies setting up this committee increased from 45.4 % in 2001 to 91.1 % in 2006. This complies with the Code.

Similarly, the table indicates that the mean number of companies that formed nominating committees (NOMC) is 81%. This complies with the Code.

The executive directors hold, on average, about 5.5% of the outstanding shares (MOWN) in their firms. The yearly data shows that the means hover around 5.3 to 5.7 %.

The mean value of percentage ownership by independent directors (OOWN) is only marginal as compared with other shareholder that is 0.2%. According to LR, independent shareholders cannot be a major shareholder and therefore, their ownership cannot exceed 5% of the aggregate of the nominal amounts of all the voting shares in the company.

In contrast, the mean of institutional ownership (IOWN) averaging across all firms is 53 %. This shows that Malaysian firms have concentrated ownerships as concurred by results shown in Claessens and Fan (2002), Haniffa and Hudaib (2006) and Tam and Tan (2007).

On the other hand, the average percentage foreign ownership (FOWN) is 10%. The mean of 9.9% in 2000 climbed up steadily to 11.5% in 2006.

On average, the natural logarithm of total assets size of the firms (LNTA) is 8.7. The yearly mean also indicate similar size.

The mean for the gearing ratio (GEAR) is 54.9%. The yearly data shows a decline in gearing from 75% in 2002 to 49% in 2006.

## 5.2 Multiple regression results

Table 6 presents the correlation matrix for the dependent and continuous independent variables. Although these univariate results show the relation between corporate board and ownership structures and performance, the analysis does not control for other factors of performance. We therefore extend our analysis to a multiple regression setting using the GMM system estimator. Before that, we first examine multicollinearity problems among the independent variables in our model. It indicates multicollinearity problem between remuneration and nominating committees. These two variables are dummy variables with value of 0 or 1. Based on the high degree of correlation, remuneration committee is removed from the model (Gujerati, 1999).

In Table 7, we report the GMM system estimates for both performance measures based on robust standard errors.

### a) Board Size

The results show that the board size is significantly associated with ROA and both performance show negative coefficients. The negative result supports the findings of Yermack (1996) and Lipton and Lorsch (1992) that smaller boards are perceived to be more effective as compared to bigger boards as over sized boards may give rise to coordination problems. Lipton and Lorsch recommended a board size of eight to nine, which is similar to the mean board size of this study. Thus hypothesis 1 is supported. MCGG does not prescribe any optimum board size but leave it to individual firm to decide on its appropriate board size.

### b) Board Composition

Contrary to expectation of MCGG and agency theory, the effect of board composition (BRDC) on firm performance yields a significant and negative relationship with ROA at the 1% level. Even though the market result does not yield a significant relationship but the coefficient is negative. These negative results are consistent with the findings of Goodstein et al. (1994) that having a high percentage of independent directors may stifle strategic actions, lack business knowledge to be truly effective and lack real independence (Demb & Neubauer, 1992) or they may be coerced by management to be passive in return for an attractive reward in the company (Abdullah, 2006; Cho & Kim, 2007; Ngui et al., 2008). Thus hypothesis 2 is not supported.

### c) Role Duality

Role duality is significantly related to ROA but in the negative direction at the 1% level. Even though, the market result is not significant, the regression coefficient is negative. The negative result is similar to the findings of Haniffa and Hudaib (2006) and Jensen (1993) who observed that role duality gives too much unfettered power of decision to only one individual. Such power may most likely cause him to pursue his own interests instead of shareholders. Agency theory advocates the separation of role as role duality reduce the monitoring effectiveness of the board over management. In a similar vein, MCGG also exhorts PLCs to separate the role of chairperson and CEO. Thus hypothesis 3 is supported for accounting performance measure.

### d) Nominating Committee

The results show that the nominating committee is significantly related with ROA for at 1% level but in the negative direction. Even though the market result is not statistically significant but it is in the same negative direction. This is contrary to MCGG. Thus hypothesis 6 is not supported.

**Table 6.** Correlation Matrix of Combined Sector

Correlation	ROA	TOBINQ	BSIZE	BRDC	DUAL	REMC	NOMC	MOWN	OOWN	IOWN	FOWN	LNTA	GEAR
2001-2006													
ROA	1												
TOBINQ	-0.122***	1											
BSIZE	0.185***	-0.095***	1										
BRDC	-0.081***	0.11***	-0.279***	1									
DUAL	-0.029	0.03	-0.102***	0.023	1								
REMC	0.072***	-0.152***	0.081***	0.065***	0.016	1							
NOMC	0.078***	-0.154***	0.081***	0.056**	-0.003	0.916***	1						
MOWN	0.01	-0.017	-0.071***	-0.032	0.112***	0.043*	0.045*	1					
OOWN	0.026	-0.043*	0.134***	0.017	0.018	0.047**	0.043*	0.073**	1				
IOWN	0.083***	-0.062***	0.128***	-0.058**	-0.098***	-0.029	0.001	-0.319***	-0.014	1			
FOWN	0.075**	0.126***	0.122***	-0.021	-0.033	-0.058**	-0.1***	-0.153***	-0.042*	-0.462***	1		
LNTA	0.193***	-0.244***	0.356***	-0.016	-0.025	0.038*	0.061***	-0.196***	-0.056**	0.224***	0.155***	1	
GEAR	-0.654***	0.154***	-0.155***	0.063***	-0.008	-0.129***	-0.136***	-0.011	-0.017	-0.064***	-0.073***	-0.093***	1

Table 7. GMM Results of Combined Sectors

Variables	2001-2006	ROA	Tobin Q
BSIZE		-0.0052*** (0.0018)	-0.0131** (0.0055)
BRDC		-0.0013*** (0.0003)	-0.0008 (0.0006)
DUAL		-0.0657*** (0.0121)	-0.0198 (0.0337)
AUDC			
NOMC		-0.0251*** (0.0094)	-0.0024 (0.0213)
MOWN		0.0007** (0.0003)	-0.0036*** (0.0010)
OOWN		0.0048** (0.0021)	-0.0304*** (0.0068)
IOWN		0.0005* (0.0003)	0.0048*** (0.0008)
FOWN		-0.0020*** (0.0005)	0.0067*** (0.0013)
LNTA		0.0647*** (0.0172)	-0.2693*** (0.0534)
GEAR		-0.1555*** (0.0068)	0.0242*** (0.0079)
Year Dummies		Included	Included
Industry Dummies		Included	Included
Constant		-0.6094*** (0.1709)	1.3927** (0.5579)
Observations		1465	1465
Sargen test of over-identifying		0.6648	0.0569
Arellano –Bond test for AR(1)		-2.5783***	-3.0578***
Arellano-Bond test for AR(2)		0.1677	1.1626

\* Significant at the 10% level; \*\*Significant at the 5% level; \*\*\* Significant at the 1% level. Robust standard errors are in parentheses.

BSIZE = board size defined as the number of directors in the board. BRDC = board composition defined as the percentage of independent directors in the board. DUAL = role duality define as t the separation of role between chairman and CEO. NOMC = defined as the presence of nominating committee. MOWN = the shareholding by executive directors (ED) defined as the % of shares held by ED. OOWN = shareholding by independent directors (IND) defined as the % of shares held by IND. IOWN = shareholding by institutional investors (II) defined as the % of shares held by II. FOWN = shareholding by foreign investors (FI) defined as the % of shares held by FI. LNTA = logarithm of total assets. GEAR = gearing defined as the total debt over total asset.

#### e) Executive directors' shareholding

Executive directors' shareholding (MOWN) is found to be significantly related to ROA at the 5% level.

The positive regression coefficient implied that executive directors' shareholding provide incentive for alignment of management and shareholders' interests resulting in better firm performance as

confirmed by Jensen and Meckling (1976). This finding supports agency theory, which advocates the adoption of good CG practices to discipline any expropriation behavior of management. On the other hand, the relationship is significant but negatively based on market performance. The market perceives that the executive directors will misappropriate firm's wealth to the detriment of minority shareholders as discovered by Khatri et al. (2002). In their study of the relationship between Malaysian corporate sector performance and corporate governance before the Asian financial crisis, they found that Malaysian companies had high concentrated ownership structure with complex cross holdings and poor debt management. Their results indicated that these features increased the vulnerability of the firms and therefore more likely to be susceptible to crisis. Thus, hypothesis 7 is supported.

#### **f) Independent directors' shareholding**

Shareholding by independent directors (OOWN) is found to be positively significantly related with accounting performance at 5% level. Proponents of agency theory argued that independent directors who owned shares might mitigate agency problems caused by dispersed ownership. Bhagat and Black (2000) found positive relationship between firm performance and independent directors' shareholdings. In contrast, the market result is negatively significant. Several empirical evidences (Morck, 2004; Berle & Means, 1932) pointed out that such shareholdings had negative impact on firm performance as independent directors could have a misplaced sense of loyalty to dominant CEO instead of challenging their decisions. They might corroborate with management because of their non-independence. Thus, hypothesis 8 is supported.

#### **g) Institutional shareholding**

With respect to institutional shareholding, the results are significant and positive for both performance measures. These results concurred with many prior studies such as in the U.S. (Guercio & Hawkins, 1999; McConnell & Servaes, 1990; Nesbitt, 1994), European countries (Becht, Franks & Rossi, 2009; Gorton & Schmid, 2000, Thomsen & Pedersen, 2000) and Asia (Morck, Nakamura & Shivdasani, 2000; Park & Chung, 2007; Sarkar & Sarkar, 2000). the market perceives institutional investors to be good monitors on management as they focused more on firm performance and less on self serving behavior (Guercio & Hawkins, 1999). Therefore it can be concluded that the institutional investors align the interests of management with that of shareholders as they hold substantial stakes in the companies. Thus, hypothesis 9 is supported.

#### **h) Foreign Shareholding**

The impact of foreign shareholding on accounting return is significant but negative. Such foreign shareholders might not be effective monitors because of their close involvement with management in running of businesses (Redding 1996). They corroborate with management to expropriate minority interests. However, the market result revealed that the market performance improve significantly at 1% level ( $p < 0.01$ ) as the level of foreign shareholding increases implying that they are able to minimize self-serving behavior of management. In addition, foreign ownership brought about benefits such as higher managerial talent, access to advance technology and entry into capital as found in prior empirical evidences (Tam & Tan, 2007; Che Haat et al. (2008)) also found such relationship in their study. Thus, hypothesis 10 is supported

#### **i) Firm Size**

Both measures are significant but in the opposite direction. Firm size (LNTA) is found to be positively associated with accounting return which implies that bigger firms seem to produce favorable results. However, the market return supports the findings of Anderson and Reeb (2003) and Haniffa and Hudaib (2006) suggesting that the market perceives smaller firms to be better performers as they are more creative, innovative and ready to change in order to increase firm performance. Thus, hypothesis 11 is supported in both periods.

#### **j) Gearing**

The negative result for accounting measure suggests that higher leverage leads to poorer performance which supports the argument that banks and creditors may not be effective monitors because of their close working relationship with management. Furthermore, they may also have multiple directorships in other firms which may compromise their commitment to the firm (Claessens et al., 2000b; Suto, 2003). Past research also found that in cases of excessive debt financing, equity owners may encourage firms to engage in risky projects to the detriment of other investors (Downen, 1995; McConnell & Servaes, 1995; Short & Keasey, 1999; Tam & Tan, 2007; Weir et al., 2002). On the other hand, the significant and positive relation between gearing and market return at 1% ( $p < 0.01$ ) indicates that the market is more confident with the monitoring by firms' creditor which confirms prior studies (Che Haat et al., 2008; Haniffa & Hudaib, 2006; Jensen, 1986). Thus, hypothesis 12 is supported.

Following Roodman (2009), Sargen test and Arellano-Bond second order autocorrelation test (AR2) are conducted to assess the reliability of our estimates as well as to ensure that our results do not encounter methodological problems. The Sargen test



allows the testing of the null hypothesis that instruments are not correlated with the error terms and thus tests the validity of the instruments. The AR2 tests the null hypothesis there is no second-order serial correlation in the disturbance term (Roodman, 2009). If the two hypotheses are not rejected, it implies that the system GMM approach is an appropriate model for our analysis. In the analysis found in the bottom of Table 5.13, the Sargen tests result are not significant indicating that the instruments are valid and are not correlated with the error term. The Arellano-Bond (AR1) tests are all statistically significant, suggesting that the levels used to instrument the first differenced equation provide weak instruments. However, AR2 test result fail to reject the null hypothesis thus providing evidence that the error terms in the system of equations are not serially correlated and orthogonality has been achieved (Roodman, 2009). These tests indicate that the GMM system approach is valid.

## 6. Conclusions

### 6.1. Overview of findings

In this study, we use the system GMM approach to examine the relationship between board and ownership structures and firm performance. We draw from the agency (Jensen & Meckling, 1976; Shleifer & Vishny, 1986), stewardship (Donaldson & Davis, 1994) and resource dependency (Pfeffer and Salancik, 19783) theories to examine the issue. Using data drawn from Bursa Malaysia for the period 2001–2006 inclusive, we find that, the mean of board size reduced while proportion of independent and foreign ownership increased even though marginally. On the other hand, the means of the executive and independent directors' share ownership and institutional shareholding remain the same. Firm performance (Tobin's Q and return on assets) is negatively related to board size, proportion of independent directors and role duality. On the other hand, the relationship between performance and executive directors' share ownership is positive for ROA but negative for market return. Overall, the results suggest that small boards, smaller proportion of independent directors in the board and non role duality increase firm performance. These findings are interesting and support the literature suggesting that smaller boards are seen as more effective in monitoring performance as the free rider problem does not exist. As for independent directors, they must be constantly reminded to discharge their duties in the best interests of the shareholders during their training. Role duality may cause the person holding the two roles to pursue his own interests to the detriment of the firm. Therefore, the recommendation by MCCG to separate the two roles should be considered. However, the accounting results suggest that firm performance improves with executive and

independent directors' and institutional shareholding (as well as market return). These are effective mechanism to resolve the agency problems especially the institutional investors. However, foreign ownership give contrasting results; negatively related to accounting return but positively to market return. These two groups of investors should be enlisted to engage actively in its monitoring role on management because of their sizable ownership stake in the organization. They can further strengthen corporate governance practices in the firms.

In interpreting the results, however, some limitations need to be noted. First, we examined only a limited number of corporate governance variables. Other board structures such as the composition of the audit, remuneration and nomination committees and board meetings may also be associated with firm performance. Secondly, the ownership identities of large shareholders have not been identified as they may have different investment objectives and strategies, and culture, which will affect firm performance and possibly the type of CG mechanisms employed. However, given the limited data, these variables could not be included in the analyses.

In spite of the limitations, these results have implications for both local and international investors. They are also relevant to policy-makers and firms in emerging countries, as they attempt to improve corporate governance. The results suggest that corporate governance regulations need to consider the nature of the environment rather than adopting a one-size-fits-all approach to corporate governance (Coles, Daniel and Naveen, 2008). Further analysis can also be done to distinguish between those investors that may have business relationships with the firms and those that have no such relationships. It will also be interesting to look at the effect of employee ownership on firm performance.

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