FIRM PERFORMANCE AND BOARD STRUCTURE: AN EMPIRICAL INVESTIGATION BEFORE AND AFTER THE ADOPTION OF THE MALAYSIAN CODE ON CORPORATE GOVERNANCE

BY

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ABSTRACT

Examining the monitoring mechanisms used by the boards of directors can give an insight into how firms resolve the agency problems between top management and shareholders. The present study investigates the relationship between firm performance and board structure of the top fifty public companies listed on the main board of the Kuala Lumpur Stock Exchange. With the publication of the Malaysian Code on Corporate Governance in March 2000, the study is trying to examine the effect of the adoption of the Code on corporate governance issues such as board composition and board size. Regression tests carried out on empirical data obtained from the secondary sources provide a measure of approaches to the study for two years i.e. 1999, the pre-adoption of the Malaysian Code on Corporate Governance and the year 2000, the post-adoption period. The findings show that the composition of independent non-executive directors does add value to firms and that the board size appears to be negatively related to firm performance. It is also noticed that most sample firms have already had a large composition of non-executive directors in 1999, and a further increase in the year 2000, results in an inverse direction, as too many outweighs the benefit over the cost. Thus, firms having boards totally independent from management may be dangerous because in making decisions, boards may need information that inside directors have but outside directors lack.

ملخص الدراسة

تهدف هذه الدراسة إلى اختبار مدى فعالية آلية الرقابة المستخدمة من قبل مجالس إدارة الشركات، وذلك بهدف الوقوف على الكيفية التي تقوم بها هذه الشركات لحل مشاكل الوكالة بين مجالس الإدارة من جهة وحاملي الأسهم من جهة أخرى، ومن أجل ذلك فقد تم بحث العلاقة بين أداء الشركات وتركيبة المجالس الإدارية لأهم خمسين شركة مسجلة في القائمة الرئيسية لسوق تبادل الأسهم في كولا لامبور.

قامت هذه الدراسة باختبار اثر تبني نظام إدارة الشركات - الذي نشر في شهر آذار عام 2000م- على القضايا المتعلقة بإدارتها حيث تم التركيز في هذا المجال على تركيبة المجلس الإداري وحجمه. ومن اجل أن يتسنى للدراسة القيام بهذا الاختبار فقد تم استخدام أسلوب تحليل الانحدار الإحصائي وذلك بالرجوع إلى البينات الإحصائية المنشورة في المصادر الثانوية المتعلقة بموضوع هذا البحث، بحيث تم اختيار سنتين لتكونا مجالا للدراسة: السنة الأولى كانت 1999م وقد اختيرت بسبب أنها تعد سنة سابقة للعمل بنظام إدارة الشركات السابق الذكر، والسنة الثانية كانت 2000م التي تم اختيارها بسبب أنها كانت سنة لاحقة لذلك.

لقد أظهرت نتائج هذه الدراسة أن التركيبة المستقلة للإدارة غير التنفيذية- قد أسهمت إلى حد ما في إضافة قيمة ذات دلالة على أداء الشركات، بينما ارتبط حجم تلك الإدارة بعلاقة عكسية مع ذلك الأداء. كما لوحظ أن معظم أفراد العينة من الشركات المختارة حققت استقلالية كبيرة للإدارة غير التنفيذية عام 1999م، وازدادت تلك الاستقلالية في عام 2000م. لكن هذه النتائج أظهرت في نفس الوقت أن المنافع كانت تضاهي الكلفة، غير أن استقلال مجالس الإدارة بشكل كامل عن الإدارة التنفيذية شكل خطورة معينة على تلك الشركات، وذلك لأنه في حالة صنع القرارات، فان مجالس الإدارة تحتاج إلى معلومات دقيقة غير متوفرة لديها وإنما تكون متوفرة على مستوى الإدارة التنفيذية.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion, it conforms and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science in Accounting.

Hafiz-Majdi Ab Rashid
Supervisor

I certify that I have read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science in Accounting.

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Examiner

This dissertation was submitted to the Department of Accounting and is accepted as partial fulfillment of the requirement for the degree of Master of Science in Accounting

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Mohd Azmi Omar
Dean, Kulliyyah of Economics
and Management Sciences

DECLARATION

I hereby declare that this dissertation is the result of my own investigation, except where otherwise stated. Other sources are acknowledged by footnotes giving explicit references and a bibliography is appended.

Name: NAWAL BINTI KASIM

Signature ______________ Date 30/9/2002

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Affirmed by Nawal binti Kasim

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Date

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CHAPTER ONE

INTRODUCTION

The issue of corporate governance has become the focus of increased shareholders' attention as companies and their directors are held to higher levels of accountability for the use of shareholder funds (Carson & Simnett, 1998). Recent developments in corporate governance have forced companies' strategies to keep abreast with the changing business environments. Even though the fundamental roles of the management teams have not changed radically, the level of performance expected from the group has dramatically risen. An interesting issue is whether we will see a global convergence of approach to corporate governance.

Webster's International Dictionary (1971) defines the term 'governance' as follows:

(i) "to exercise arbitrarily or by established rules continuous sovereign authority over", and

(ii) "to rule without sovereign power; to implement and carry into effect policy decisions over without having the power to determine basic policy".

Corporate governance is the process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realizing long term shareholder value, whilst taking into account the interest of other stakeholders" (Malaysian Finance Committee, 2000).

From time to time, the need for a global approach to corporate governance has become all the greater. Contemporary research by leading academics is calling to question the appropriateness of developing a uniform approach to corporate governance. In the United Kingdom, the world's first Code of Best Practice for Corporate Governance was issued in 1992 by the Cadbury Committee, which claimed to be the best practices being followed in listed companies. The committee had similar roots to the United States' equivalent Treadway Commission, which was set up in 1987.

The stimulus for Treadway had been fraudulent financial reporting of Wall Street listed companies while the specific stimulus for setting up the Cadbury Committee had been the conspicuous corporate collapses of the late 1980s – BCCI, The Maxwell Corporation, British and Commonwealth – in both cases, it was the lack of trustworthiness of directors and senior managers (Chambers, 2000).

Later, in September 1995, came the Greenbury Report[1] on directors' remuneration, following the seminal Cadbury Code of Best Practice. The Hampel Committee[2] was later set up to consolidate, amend, and add to the Cadbury and Greenbury Codes in the form of the new Combined Code (1998). More recently, we also see the development of other corporate governance codes and principles such as the COSO (1992)[3], the King Report from South Africa (1994)[4], the work of Toronto Stock Exchange

[1] Greenbury Committee (1995): *Directors' Remuneration.*
[2] Hampel Report: *Final Report* (a reference made by the Malaysian Code on Corporate Governance).
[3] Committee of Sponsoring Organization of the Treadway Commission (September, 1992): *International Control – Integrated Framework.*
[4] The Institute of Directors in Southern Africa (1994): *The King Report on Corporate Governance*

Committee on Corporate Governance (1994)[5] and the work of Canadian Institute of Control Committee (1995)[6].

Malaysia is not an exception when talking about the corporate governance issues. Stockbrokers in Malaysia are in a depressed mood. Commission rates for all trades above RM100, 000 have become fully negotiable and this is followed by liberalization of retail trades (Pollock, 2001). The brokers feel the market has been marginalized as the volumes are down. The explanation for this development can be summarized in two highly charged and politically sensitive words: corporate governance.

Some examples of Malaysia's corporate governance problem are the UEM-Renong saga and the sale of the Malaysian Airline System's Chairman's stocks. However, the problem of poor corporate governance is not by any means limited to such companies only. The inter-company loan of the Berjaya group, the bail-out of Star Cruises by the Genting Group, the offer of buying 44% of Dyna Plastics by Gamuda, the proposed new corporate structure for the Arab Malaysian Merchant Bank Holdings and a few others remain serious issues to the public. Partly as a result, the Malaysian Code on Corporate Governance was published in March 2000.

The need for the code also results from the economic forces and the need to reinvent the corporate enterprises, so as to efficiently meet emerging global competition (Malaysian Finance Committee, 2000). In developing the code, the committee had

[5] CICA (1994): *Where Were the Directors.*
[6] COCO (1995): *Control and Governance Series of the CoCo Board.*

based on the approach[7] taken by the Hampel Committee. Since there is a lack of corporate governance standards for Malaysian listed companies, there is a need to raise these standards by requiring not only disclosure, but also prescriptions for the corporate governance practices of the companies.

The standard code on corporate governance was developed to set out principles and best practices on structures and processes that companies may use in their operations towards achieving the optimal governance framework. One of the best practices laid down in the Malaysian Code on Corporate Governance by the Finance Committee on Corporate Governance, which attracts my attention, is the board composition of inside and outside directors, which constitutes an effective board. It states that,

> "...to be effective, independent non-executive directors need to make up at least one third of the membership of the board."

Further discussions on the recommendation will be provided in Chapter Two of this paper.

In the United States, the key trends for corporate boards are "smaller, more independent and more diverse" (Marshall, 2001). The changes are evolutionary, and efforts to recruit majority of outside independent directors tend to fall into a debate. In the 1960s, most companies had a majority of inside directors. However today, almost all have a majority of outside directors and has become the trend towards greater board independence (Bhagat and Black, 1999). These phenomena and other board's

[7] The hybrid approach- applying broad principles flexibly and with common sense to suit circumstances.

trends, such as awarding stock grants to directors, to make them more like major shareholders, have been affecting corporate governance in companies everywhere.

Although the basic principle is that directors are selected for their competence, useful skills and experience, effective boards should take into consideration the independence of the non-executive directors. It is normal for certain companies to have managers and directors among the owners. However, there is merit in having at least one non-executive director who is independent and can bring objectivity and will put the interests of the firm first. He is someone who is not engaged in the day-to-day operations of the firm and is thus expected to bring an outside view to the board table.

According to Huria (2001), an independent non-executive director can provide the following:

- A wider general experience of strategy formulation than is available within the company's senior salaried staff.
- An independence that is not influenced by considerations of career status or personal gain.
- An objective view of the performance of management in attempting to achieve the results set in the company's strategy.
- Professionalism to ensure that the board uses adequate systems to safeguard the interests of the company even though these may conflict with the personal interests of the executive directors.

In the corporate context, governance issues are becoming one of the important agenda being discussed at board's as well as shareholders' meetings. Controversies surrounding board composition and directors' ownership of equity are among the topics of interest Due to this scenario, corporate structure and its relation to firm value have long been of interest to corporate governance researchers. Board composition, in particular, has been the focus of much attention (Klein, 1998, Barnhart and Rosenstein, 1998, Hermalin and Weisbach, 1991).

This study attempts to obtain evidence on whether good corporate governance in terms of greater board independence and board size will result in a higher firm performance. For the purpose of the study, the presence of non-executive members of the board implies the independence element, and independent is defined in the Cadbury Code of Best Practice as 'independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement'. Non-executive directors should be persons of calibre, credibility and have the necessary skill and experience to bring an independent judgment to bear on the issues of strategy, performance and resources including key appointments and standards of conduct (Malaysian Finance Committee, 2000).

Good corporate governance contributes to wealth creation; internally within the firm as well as by building the confidence of investors or potential investors and thus reducing the cost of capital. To achieve good governance, of course, a company needs strategies and policies relating to corporate governance such as the code on corporate governance. In Malaysia, best practices on corporate governance are laid down in the Malaysian Code on Corporate Governance, which was established in March, 2000.

The study is concerned with the period prior to the adoption of the Malaysian Code on Corporate Governance (year 1999) and, for comparison purposes, the post-adoption period (year 2000). It is expected that the period after the adoption will present a better result in terms of firm performance, as companies have more structured corporate governance. This is because they will be guided by a standardized policies and procedures in terms of disclosure and practices.

The main objective of the study is to evaluate the relationship between firm performance and a corporate governance mechanism of board composition. This leads to the hypothesis that firms with greater board independence in terms of high percentage of outside directors will perform better than those with lower percentage of outside directors. We estimate a straightforward model of the relation between firm performance and board composition of outside directors. We follow the method of related study of Hermalin and Weisbach (1991), by regressing the main independent variable of board composition against two measures of firm performance. First, the market capitalization itself, and second, an approximation of Tobin's Q, which measures the ratio of a firm's market capitalization plus the liquidating value of preference shares plus short-term liabilities and divided by the total assets (Chung and Pruitt, 1994). Besides the board composition as the main independent variable, this study also investigates whether board size influences firm performance. It is an attempt to obtain evidence that larger boards are not necessarily more effective than smaller boards. We also include control variables such as firm size, leverage and industry variable.

The study covers the top 50 well-performing firms of various industries in terms of specific criteria mentioned in the research design. It addresses the empirical importance of the interdependence between board composition and firm performance with reference to the listed companies in Malaysia. The study is expected to add further evidence that suggests outside directors are valuable with their role as monitors of management and providers of relevant 'complementary knowledge' (Fama and Jensen, 1983) that will add value to the firm. It is hoped to contribute to the empirical literature that examines whether boards of directors are important and whether board structure of the Malaysian listed companies is a factor, which influences corporate performance. With a small sample size and some approximations on the measure of the variables, these could hinder the generalization of empirical results of this study. The detailed discussion on the limitations and further extensions of the study are provided in Chapter Six.

The rest of the dissertation are structured as follows:

Chapter Two presents the institutional settings which have governed the recommendations by various corporate governance committees, particularly in Malaysia. Chapter Three reviews previous literatures on the relationship between corporate governance and firm performance. The literatures are looked into from the theoretical as well as empirical perspectives. Chapter Four then lays down the design of the research, which includes the hypothesis development, sample selection, variables definitions and empirical modeling. Chapter Five presents the empirical results and Chapter Six provides the conclusion.

CHAPTER TWO

INSTITUTIONAL BACKGROUND OF CORPORATE GOVERNANCE IN MALAYSIA

This chapter discusses the recommendations and suggestions by various corporate governance reports, specifically on the Malaysian Code on Corporate Governance.

CORPORATE GOVERNANCE REPORTS

The Cadbury Committee was set up in the early part of the Thatcher years, in 1991, and produced a report of the committee on the financial aspects of corporate governance (the Cadbury Report) towards the end of 1992. It was the unfavorable economic climate of the late eighties and early nineties which had exposed company reports and accounts to unusually close scrutiny, together with continuing concern about standards of financial reporting and accountability, experienced by BCCI, Maxwell and the controversy in the UK over directors' pay (Chambers, 2000). Weak corporate governance and poor internal control systems lay behind many of these business failures. All these had brought various issues on corporate governance into the public eye. It was for these reasons that the Cadbury Committee was set up by the Financial Reporting Council, the London Stock Exchange, and the accountancy professions in the UK to address the financial aspects of corporate governance. Among others, the Committee's Code of Best Practice recommended that the majority of non-executive directors on a board should be independent. Its central recommendation was that the boards of the listed companies, should comply with the Code and also encourage other companies, which are not listed on the London Stock Exchange, to aim at meeting its requirements.

Subsequent to the seminal Cadbury Code of Best Practice came the Greenbury Report, a result of the recommendations by the Greenbury Committee, on directors' remuneration was published in early 1995. Its main concern was about the transparency of corporate disclosure and its main recommendation is to increase the disclosure requirements on directors' remuneration in terms of basic salaries and bonus schemes. Most recently, we have had the Hampel Report, which consolidated, amended and added to the Cadbury and Greenbury Codes in the form of the new Combined Code. This new Combined Code applies to companies listed in the UK for years ending on or after 31 December 1998.

Five years earlier than the U.K.'s Cadbury Report, the U.S. had come out with a report (the Treadway Report) through its Treadway Commission in 1987. It came out of concerns about fraudulent financial reporting. Other corporate governance committees established in the U.S. were the Public Oversight Board and the Kirk Panel. Among others, their recommendation was to appoint entirely independent outside directors in the audit committee.

Besides the development in the U.K. and the U.S., there are a string of other corporate governance reports produced by other countries that are also trying to promote better corporate governance systems within companies in their countries. Among them are the King Report from South Africa (1994), the Dey Report prepared by Canada's

Toronto Stock Exchange Committee on Corporate Governance (1994), the 'Control and Governance Series' by the CoCo Board (Canadian Institute of Chartered Accountants' Criteria of Control Committee) and the Vienot Report from France (1995).

The Australian Stock Exchange had taken a non-prescriptive approach which simply required corporate governance practices in a company to be disclosed in the annual report starting 1996. In Japan, the Corporate Governance Forum of Japan was established in 1998 suggesting on improved disclosures and board independence. More recently, we have also seen the development and publication of both the Commonwealth and the Organization for Economic Co-operation and Development (OECD) corporate governance codes. Both were published in 1999.

THE MALAYSIAN CODE ON CORPORATE GOVERNANCE

The Asian economic crisis has brought with it an urgent need for reforms in both the public and private sectors in East and Southeast Asian countries. Mismanagement, cronyism, nepotism and corruptions that prevailed in both government and private sectors have been accounted for the crisis. To tackle and to prevent such a crisis in the future, reforming the political system, the bureaucracy and businesses along the line with the good governance concept has been a necessity. In Malaysia, the government hand in hand with the corporate sectors is trying to make good governance as a national agenda.

Previously Malaysian corporations were those family-owned businesses and family-controlled companies and therefore corporate governance was largely a family matter with no element of accountability to anyone but the family. Later, when corporations from other countries such as the U.S. and Japan invested significantly in Malaysia through wholly-owned corporations or joint-ventures with local firms, and evolved into public-listed corporations, the question of corporate governance became more apparent in the Malaysian economic scenery. The corporate scene has changed and the KLSE has grown to such an extent that there are over 700 companies listed on its Main Board and over 300 on its Second Board. The governance of such corporations and the responsibilities that go with it is no longer as simple as the early stages of its evolution.

The Malaysian Code on Corporate Governance was developed by the Working Group on Best Practices in Corporate Governance and subsequently approved by the Finance Committee on Corporate Governance. The purpose is to set up principles and best practices on structures and processes that companies may use in their operations towards achieving the optimal governance framework (Malaysian Code on Corporate Governance, 2000). It follows a prescriptive approach, which is similar to the Hampel Report.

There are basically four forms of recommendations:

- Principles: whereby companies are required to include in their annual reports a narrative statement of how they apply the relevant principles to their particular circumstances.

- Best practices in corporate governance: which require companies to state in their annual reports the extent to which they have complied with the standards of best practices.
- Exhortations to other participants: this voluntary disclosure requirement is addressed to investors and auditors to enhance their role in corporate governance.
- Explanatory notes and "mere best practices": this explains the principles and best practices in detail.

The KLSE has later on incorporated the recommendations by the Malaysian Code on Corporate Governance Committee into its listing requirements. In its major revamp of the Listing Requirement on January, 2001, it has included a specific chapter, Chapter 15, to deal with the corporate governance issues. The requirement in that chapter is effective for all public listed companies from 1st June, 2001.

Paragraphs 15.26 and 15.27 specifically spell out the disclosure requirements for corporate governance information. Due to some expectations of difficulty in implementing these requirements, KLSE has issued a Practice Note No. 9/2001 to facilitate the implementation of the requirements in paragraphs 15.26 and 15.27. Among the guidelines given in the practice note is the suggested location of the Corporate Governance Statement and the Internal Control Statement in the annual reports. These two statements must not be incorporated into the Chairman's Statement.

It is also important to take note that there are two main parts of the Corporate Governance Statement: 1) a narrative statement on application of the principles, and 2) a statement on the extent of compliance with the Best Practices. The KLSE further makes a detailed description on the content of the compliance statement with the Best Practices and Internal Control statement. It is hoped that by disclosing these information, public listed companies will be more transparent in their monitoring and internal control systems, and thus enhancing their performance.

After discussing the importance of the corporate governance issues especially in the Malaysian context, we will then proceed further to look into the theoretical background and the empirical literatures behind these issues.