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How MCCG 2012 Impacted Board Independence and Firm Performance In Malaysia: A Proposed Analysis

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Abstract

Purpose: The renowned agency theory and Corporate Governance (CG) codes around the world advocate independence of corporate boards. It is a common belief of the public, investors, regulators and policy makers that CG regulations strengthen independence of the board which improves firm performance. Hence, this paper proposes to test the common belief by examining the relationship between board independence as recommended by the recently introduced CG code (MCCG 2012) in Malaysia and financial performance of the listed companies from 2010 to 2013 in pre and post context of the code.

Design/methodology/approach: This theoretical paper proposes to examine the impact of CG regulation (MCCG 2012) regarding board independence (separate leadership structure, proportion of independent non-executive directors on the board and independent chairman) on firm performance by using Ordinary Least Square (OLS) for a stratified random sample of 270 companies from all sectors of the Malaysian economy except banks and insurance companies.

Findings/ highlights: The proposed study will provide empirical evidence to the inconclusive debate regarding the relationship between board independence and firm performance in the context of regulatory intervention (MCCG 2012). The study will also fill the literature gap as MCCG 2012 or any of its recommendation in relation to firm performance is yet to be investigated in Malaysia.

Practical implications: The recommendations of MCCG 2012 regarding board independence (separate leadership structure, proportion of independent directors and independent chairman) are voluntary (comply or explain) and not part of the mandatory listing requirements of Bursa Malaysia yet. Thus, the empirical findings of the proposed investigation will help reduce the level of disparity between MCCG 2012 and mandatory listing requirements of Bursa Malaysia.

Originality/value: The proposed study has value for policy makers, regulators, banks, Bursa Malaysia, shareholders, securities commission and government in Malaysia by knowing the impact of MCCG 2012 on board independence and its relation with firm performance.

Keywords: Corporate Governance (CG), Board Independence, Financial Performance, Pre-Post Analysis, MCCG 2012, Malaysian Listed Companies.

Paper Type: Research Paper

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Introduction

Corporate Governance (CG) specifies the rights, responsibilities and duties of all the stakeholders like board, managers, shareholders, creditors, auditors, regulators, government, suppliers, employees, customers, society and environment. It is a key to the survival of organizations particularly after the separation of "ownership" and "control" where decisions of the managers don't affect their own wealth much (Fama & Jensen, 1983).

Corporate Governance (CG) has become a hot issue of discussion and research for both academia and industry especially after the high-profile corporate collapses of Enron Corp. (2001), WorldCom Inc. (2002), and Global Crossing Ltd. in the USA (Petra, 2005). Though it is not easy to establish link between CG and firm performance, still it is a common belief that good governance leads to firms' better performance (Young, 2003). However, empirical results regarding CG and firm performance are mixed and inconclusive (Ponnu, 2008). Some studies show that there is no relation between corporate governance and firm performance (Karpagam, 2013), while others evidence positive relationship between them (AlMutairi, 2008; Kyereboah-Coleman, 2007; Shukeri, Shin, & Shaari, 2012; Tham, Marn, & Romuald, 2012).

Many studies found that the implementation and compliance of CG practices improves firm performance (Klapper & Love, 2004; Noor & Fadzil, 2013; Nur'ainy, Nurcahyo, Kurniasih, & Sugiharti, 2013; Velnampy, 2013). The investors of developing and emerging markets consider CG as a mechanism of profit maximization. Thus, they are willing to pay at least 10 percent premiums on their investments in a better governed company as compared to a poor governed company of the same emerging market. They rank good and poor governed companies on the basis of their financial performance particularly profitability (Khanna & Zyla, 2010). Weak compliance of CG practices, on the other hand, leads to firms' poor performance and corporate scandals like Perwaja Steel, Technology Resources Industries (TRI), Transmile Air Services Sdn. Bhd., Megan Media Holdings Bhd, Malaysian Airlines System (MAS), Port Klang Free Zone (Norwani, Mohamad, & Chek, 2011), Linear Corporation, Kenmark Industrial Company and Sime Darby Corporation in Malaysia (Satkunasingam, Yong, & Cherk, 2012).

After the separation of "ownership" and "control" investors hesitate to provide their money to corporations in absence of a sound governance structure which can ensure return of their money along with profit (Shleifer & Vishny, 1997). The legal or regulatory protection gives them this courage and confidence (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000) as the goal of CG regulations is to improve firms' governance and performance (Bhagat & Bolton, 2009; Lama, 2013).Thus, it is common to regulate corporations by CG legislations and regulations which force them to improve their governance and performance.

The Investment and Financial Services Association of Australia guidance # II states that corporate governance means improving firm performance for shareholders, stakeholders and economic growth (IFSA, 1999). In accordance, Malaysia also introduced its new CG code Malaysian Code on Corporate Governance (MCCG 2012) in March, 2012 to improve financial performance of the listed companies. However, it is yet to test whether the code could improve firm performance or not as it is also argued that regulatory interventions for disciplining company's management or improving firm performance is an open debate with contradictory arguments (Keasey, Thompson, & Wright, 1997; Vafeas & Theodorou, 1998).

The past literature shows inconclusive findings and mixed arguments regarding the relationship between CG regulations and firm performance. Moreover, the literature also exhibits gap regarding the impact of MCCG 2012 on firm performance in Malaysia. Thus, this paper proposes to investigate the impact of separate leadership structure, proportion of independent non-executive directors on the board and independent chairman as recommendations of MCCG 2012 on firms' financial performance measured by return on equity (ROE) and earnings per share (EPS) for two year pre (2010-11) and two year post (2012-13) enactment period of the code. The proposed study will provide empirical evidence that how MCCG 2012 impacted the level of compliance on board independence (separate leadership structure, proportion of independent non-executive directors on the board and independent chairman) and its relationship with firm performance. The proposed study besides filling the literature gap will contribute to policy and development of CG structure in Malaysia as all of the three recommendations of the code are voluntary (comply or explain) yet and considered to be included in mandatory listing requirements of Bursa Malaysia.

Historical Development of Corporate Governance Regulations in Malaysia

Asian financial crises in 1997-98 badly affected most of the Asian countries including Malaysia which significantly changed the scenario of CG structure in these countries. Subsequently, Malaysia like other Asian countries, besides others initiatives, introduced Malaysian Code on Corporate Governance (MCCG 2000) in 2000 for strengthening CG structure in the country. The introduction of MCCG 2000 was a formal start of corporate governance codes in Malaysia (MCCG, 2012 ; Abdullah, 2004).

In recognition of domestic and international market developments, Malaysia revised MCCG 2000 in 2007. The new code MCCG 2007 mainly addressed the board of directors and audit function of the companies. The code clarified the roles of directors along with their eligibility for appointment. The code recommended the establishment of an internal audit function and held its head responsible to report directly to audit committee for the sake of independence. Moreover, the code suggested the establishment of an audit committee, composed exclusively of non-executive directors. In addition, it was also advised that all members of the audit committee should be able to read, analyze and interpret financial statements for effective discharge of their responsibilities (MCCG 2007).

The Global Financial Crises in 2007-2008 badly affected Malaysian economy like other economies of the world as evidenced by 670 points fall in the index of Bursa Malaysia which was 45 % of its total value. It was the biggest decline after the Asian Financial Crisis 1997 in the country (Angabini & Wasiuzzaman, 2011). Subsequently, the Asian Round Table on Corporate Governance advised to improve governance structure and overcome the weaknesses exposed by the crisis in Asian countries including Malaysia (OECD, 2011). Moreover, corporate scandals and poor performance of linear corporation (2008), Kenmark Industrial Co Ltd. (2010) and Sime Darby (Sime) (2010) in post enactment period of MCCG 2007 further highlighted the need for revision of CG code in Malaysia (Satkunasingam et al., 2012). In accordance, Securities Commission Malaysia issued CG Blue print document in July, 2011 for improving governance structure of the country which facilitated the introduction of new code MCCG 2012 in March 2012 (MCCG, 2012). The code, mainly addressed independence of the board among others, with

anticipation to improve financial performance of the listed companies in Malaysia, which is yet to be investigated.

Literature Review

Malaysia had three CG codes (MCCG 2000, 2007, 2012) to date, since 2000. Many studies investigated the impact of the previous two CG codes on firm financial performance in pre and post context (Noor & Fadzil, 2013). A pre and post analysis of MCCG 2000 documented no relationship between the code and firm performance in pre-ICG (Implementation of Corporate Governance). However, the relationship was found positive in post-ICG period (Saad, 2010). The impact of MCCG 2007 practices regarding board independence, board expertise and audit committee expertise investigated in relation to financial performance of Malaysian Govt. linked companies (GLCs) in pre and post context. The results evidenced that only expertise of audit committee positively impacted financial performance of GLCs in post context of the code. The results supported new recommendation of the code (MCCG 2007) that all members of the audit committee should be able to analyze and read financial statements of the company (Hamid & Aziz, 2012).

The impact of MCCG 2007 was analyzed in relation to firm performance in pre and post context for two years i.e. 2006 and 2008. The study found significant positive relation between board characteristics and firm performance in post context of the code (Noor & Fadzil, 2013). Another study examined the relationship between CG practices of MCCG 2007 and firm financial performance in pre and post context. The study found that CG practices of board and audit committee have significant positive relation with firm financial performance in post context of the code (Noor & Fadzil, 20). An examination of the relationship between CG practices and firms' performance documented weak evidence that the companies adopted MCCG 2007 (board of directors & audit committee) performed better than the companies didn't (Hussin and Othman, 2012). These empirical findings show disparity and incongruence which necessitate further investigation of the relationship between CG codes and firm performance. Moreover, the pre and post analysis of MCCG 2000 and MCCG 2007 in relation to firm performance also necessitate a similar study for MCCG 2012, which has not yet conducted. Hence, this paper proposes to examine the impact of MCCG 2012 - separate leadership structure, proportion of independent directors on the board and independent chairman on financial performance (ROE &EPS) of the Malaysian listed companies in pre and post context from 2010 to 2013.

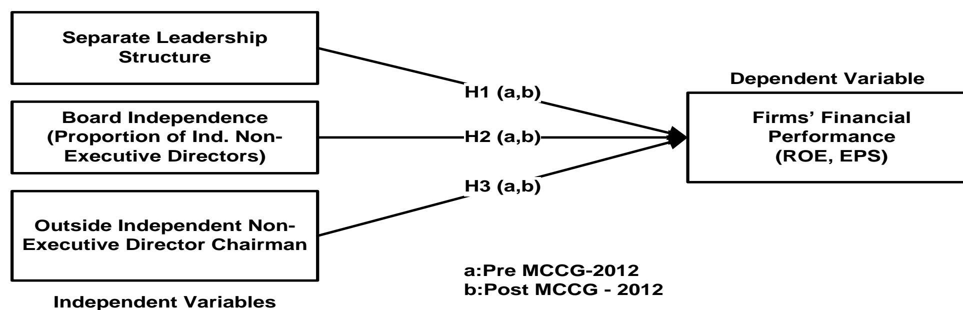

Figure 1: Proposed Conceptual Framework

Separate Leadership Structure and Firms' financial Performance

The separation of CEO and Chairman of the board is known as separate leadership structure (Petra, 2005). The agency theory suggests separation of CEO and chairman of the board for effective monitoring of managers and better performance of firms (Fama & Jensen, 1983). In accordance, the MCCG 2012 recommendation # 3.4, based on CG blue print document recommendation # 15 states that:

"The positions of chairman and CEO should be held by different individuals and the chairman must be a non- executive member of the board."

Many empirical findings documented that separating CEO and chairman of the board has significant positive (Bhagat & Bolton, 2008; Tham et al., 2012 ; Kajola, 2008) whilst the CEO duality has negative impact on firm performance (Jackling & Johl, 2009; Kiel & Nicholson, 2003; Bozec, 2005; Yusoff & Alhaji, 2012). However, besides these positive postulations and empirical findings, many studies show no or negative relationship between leadership structure and firm financial performance (Vafeas and Theodorou, 1998;Weir & Laing, 2000; Weir, Laing, & Mcknight, 2002; Dulewicz & Herbert, 2004). Ponnu, (2008) documented that there is negative relationship between separate leadership and firm performance whilst CEO duality has no negative impact on firm performance (Shukeri et al., 2012). Dey, Engel, and Liu, (2011) argued that separation of chairman from the CEO lowers firm returns.

The empirical findings regarding the relationship between separate leadership structure and firm financial performance are mixed and inconclusive which necessitate its further investigation particularly after MCCG 2012 in Malaysia. This paper, therefore, proposes further empirical investigation of the relationship in pre and post context of the code for four years from 2010 to 2013. The hypotheses of the proposed study on the basis of agency theory are:

H1 (a): Separate leadership has positive asssociation with firms' financial performance before MCCG 2012.
H1 (b): Separate leadership has positive asssociation with firms' financial performance after MCCG 2012.

Proportion of Independent Directors on the Board and Firms' Performance

The agency theory suggests that board of directors (BOD) is an important tool of internal governance to monitor management (Fama, 1980) particularly after the separation of ownership and control in companies (Jensen & Meckling, 1976). The effective monitoring role of the board requires board independence which can be assessed from the proportion of independent directors on the board (Fama & Jensen, 1983). In accordance, the MCCG 2012 recommendation # 3.5 developed in the light of CG blue print recommendation # 15 describes that:

"The board must comprise a majority of independent directors where the chairman of the board is not an independent director."

However, Bursa Malaysia listing requirements mandates that 1/3 of the board or at least 2 directors must be independent, which is clearly different from the new code. It is argued that board mostly composed of insiders (Non independent directors) weakens its approach to minimize agency problems (Claessens & Fan, 2003). Boards which ensure majority of independent non-executive directors along with the presence of inside and affiliated directors are better than the fully independent or dependent boards (Bhagat & Black,

2001). There is a significant positive relationship between firm performance and true independence of the board (Francis, Hasan, & Wu, 2012). Board independence increases the CEO's fear of removal for poor performance which improves firm performance (Masulis & Guo, 2013). Board independence has significant positive relationship with firm financial performance (Gull, Akram, Bilal, & Muzaffar, 2013) after the Sarbanes-Oxley Act 2002 (SOX, 2002) in the USA (Bhagat & Bolton, 2008; Bhagat & Bolton, 2009).

It is the belief of MCCG 2012 like Sarbanes-Oxley Act 2002, that independence of the board improves firm performance (MCCG 2012; Bhagat & Bolton, 2009). However, on contrary, many research studies proved that there is no significant link between board independence and firm performance (Abdullah, 2004; Ponnu, 2008; Tham et al., 2012; Velnampy, 2013 ; Klein, 1998). The proportion of independent non-executive directors on the board has no concern with firm performance (Amran, 2011) in pre (Bhagat & Bolton, 2008; Bhagat & Bolton, 2009) as well as post context of SOX 2002(Ness, Miesing, & Kang, 2010). Some studies even documented significant negative relationship between board independence and firm performance (Shukeri et al., 2012; Agrawal & Knoeber, 1996 ; Latif et al., 2013).

The results of the relationship between proportion of independent directors on the board and firm financial performance are mixed and inconclusive which necessitate its further investigation particularly after MCCG 2012 in Malaysia. This paper, therefore, proposes further empirical investigation of the relationship in pre and post context of the code for four years from 2010 to 2013. The hypotheses of the proposed study on the basis of agency theory are:

H2 (a): The proportion of independent non-executive directors on the board has positive association with firms' financial performance before MCCG 2012.
H2 (b): The proportion of independent non-executive directors on the board has positive association with firms' financial performance after MCCG 2012.

Independent Chairman of the board and Firms' Performance

Agency theory posits independence of the board to reduce agency problem (Fama, 1980).The separation of CEO and chairman roles and majority of independent directors on the board strengthens board independence (Fama & Jensen, 1983). However, in absence of independent or non-executive chair (outside chair) of the board, agency problem becomes more severe and complex (Coles & Hesterly, 2000). The presence of an outside independent chairman is crucial when the CEO is influential (Balsam, Puthenpurackal, & Upadhyay, 2011). Independent chair of the board is free from the influence of management which ensures better monitoring role of the board to reduce agency problem (Balsam et al., 2011). In accordance, the MCCG 2012 recommendation # 3.4 developed in the light of CG blue print recommendation # 15 also describes that:

"The positions of chairman and CEO should be held by different individuals and the chairman must be a non-executive member of the board".

The practice of independent chair of the board when proposed by Securities Commission (SC) in CG blue print document in July, 2011 remained open for public response till September 2011, before inclusion in MCCG 2012. Independent chair ensures effective monitoring of managers which leads to firm better performance (Hussin and Othman,

2012). There is an increasing trend of appointing independent chairmen in the USA on account that they have significant positive impact on firm performance (Balsam et al., 2011). The shareholders also respond positively to the announcement of independent chair of the boards (Balsam et al., 2011; Coles & Hesterly, 2000).

In contrast, it has found that outside independent chair is not only costly (Coles & Hesterly, 2000) but also of less value in the companies having complex operations (Balsam et al., 2011). The limited literature with inconclusive results regarding the relationship between independent outside director chairman of the board and firm performance necessitates its further investigation particularly after MCCG 2012 in Malaysia. Hence, this paper proposes to further investigate the relationship in pre and post context of the code. The hypotheses of the proposed study on the basis of agency theory are:

H3 (a): The independent or non-executive chair of the board has positive association with firms' financial performance before MCCG 2012.
H3 (b): The independent or non-executive chair of the board has positive association with firms' financial performance after MCCG 2012.

Measurement of Firms' financial Performance:

The selection of appropriate performance measures is important to ensure better and meaningful analysis of governance-performance relationship. The biasness in measuring firm performance must be eliminated for better diagnosis (Yusoff & Alhaji, 2012). Many studies which examined the relationship between board characteristics (composition and independence) and firm performance have used measures of return on equity (Kajananthan, 2012) and earnings per share (Karpagam, 2013; Yusoff & Alhaji, 2012).Thus, this paper also proposes to use return on equity (ROE) and earnings per share (EPS) for measuring firm financial performance. These profitability ratios will update investors regarding the impact of the code on firm financial performance as they are more interested in firm profitability (Khanna & Zyla, 2010).

Scope and Methodology of the Study

The proposed data is secondary in nature and can be collected from annual reports of the listed companies on Bursa Malaysia (Noor & Fadzil, 2013; Shukeri et al., 2012) for four years (2010-2013) representing two years pre and two years post period of the code. Bursa Malaysia had 823 listed companies on the main board and 110 companies on ACE with a total market capitalization of RM 1.287 trillion / USD 429 billion at the end of 2009 (Bursa Malaysia, 31 Dec. 2009).Thus, this paper proposes a stratified random sample of 270 listed companies from all sectors of the economy except banks and insurance companies due to their different governance requirements. The paper proposes ordinary least square (OLS) for the proposed analysis.

Conclusions and Recommendations

Agency theory suggests independence of the board as an important internal governance tool for effective monitoring of managers which improves firm performance. However, empirical findings regarding poor performance and corporate scandals of Linear Corporation and Sime Darby revealed the inefficiency of independent directors in

Malaysian perspective. Subsequently, the MCCG 2012 addressed independence of the board to improve firm performance. The code anticipates that strengthening independence of the board will improve firm performance, which is yet to test. Thus, this paper proposes to investigate the impact of board independence (MCCG 2012) on firm financial performance in pre and post context of the code.

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