

## Corporate Governance and Firm Performance

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**To Link this Article:** <http://dx.doi.org/10.6007/IJARBSS/v12-i11/15670> DOI:10.6007/IJARBSS/v12-i11/15670

**Published Date:** 14 November 2022

### Abstract

This research project is to study corporate governance and firm performance. The objective of this research is to investigate the relationship between independent variable and dependent variable. The dependent variable used in this research is firm performance whereas board size, board independence, compensation and CEO duality are considered as the independent variables. All of the variables will be further elaborate and explain in detailed. 100 listed companies by market capitalization in Malaysia will be selected to conduct this research due to they are served as industry leader in the market. In this research, secondary data approach is used to gather all the data and information. The data and information of the study will be analyzed using the Statistical Package for the Social Sciences (SPSS) computer program. The analysis consists of descriptive statistic, normality test, correlation analysis, multicollinearity analysis and regression analysis.

**Keywords:** Corporate Governance, Firm Performance, Listed Companies

### Introduction

According to Cadbury (1992), corporate governance means the system that direct and control an organization. Corporate governance also can be called as the process that carried out by the board of directors and committees to take consideration of the welfare of company's shareholders and other stakeholders. In addition, corporate governance could give authority, direction and oversights to the management. It means how to make an equal and fair distribution between the benefits of board members and the benefits of the shareholders and the other stakeholders.

On the other hand, according to Cambridge Dictionary, performance can be defined as how successful an investment and company is and how much profit the companies can earn. Firm performance is thus can be described as the effectiveness of a firm in achieving or attaining the outcomes and objectives within specified time periods. These outcomes or objectives can be explained as the measures by which the corporations is evaluated and mainly consists of the quality of corporate governance (Iwu-Egwuonwu & Chibuike, 2010).

The most common ways to measure firm performance consists of return on assets (ROA), return on equity (ROE), and earnings per share (EPS).

There are several elements that tested in this research including (1) the size of the board, (2) the duality of the CEO, (3) the presence of independent (outside) directors and (4) the compensation of the board. This research is conducted to measure the impact of those elements on the firm performance such as return on assets, return on equity and earnings per share of the firm. In addition, this study would like to investigate the relationship between corporate governance and firm performance. Good corporate governance is necessary because it is a prerequisite for maximization of shareholder wealth, helps to improve the performance of the firm and corporations as well as to create competitive and efficient business enterprises. A good corporate governance is more likely to improve the performance or effectiveness of firms and institutions, through a more efficient management, better labor practices, well allocation of assets, or similar other efficiency improvements (Claessens, 2006).

Dehaene et al (2001) is meant to investigate whether there is a relationship exists between board composition such as number of directors, presence of outside director, CEO duality and company performance that includes return on assets and return on equity by evaluating 122 companies in Belgian. Their findings indicate a significant positive relationship between percentage of outside director and ROE. For example, the performance of firm is better if there is more external director in that company. Besides that, they also found a significant positive relationship between CEO duality and ROA. For instance, the company would show higher ROA if the CEO also hold a post of Chairman of BOD. Hence, this study will be conduct in order to find out the relationships and impact of corporate governance on firm performance.

In addition, this study has evaluated different research hypotheses based on a sample of 100 listed companies. The data and information required to conduct this study is collected from the period of 2013 to 2015 of annual reports on Bursa Malaysia after the establishment of Malaysian Code on Corporate Governance 2012 (MCCG, 2012). Securities Commission has released the Malaysia Code on Corporate Governance (MCCG) on 29 March year 2012. The objective of MCCG 2012 is concentrate on reinforce board structure and promoting good corporate governance.

### **Literature Review**

The study of corporate governance initially arises from agency theory. This theory makes an attempt to explain the relationship between principals and agents of a firm or institutions. According to agency theory, an agent act on the behalf of principal to perform the works. According to Jensen & Meckling (1976), agency relationship means a contract under which one party which called principal delegates the authority to another party called agents to perform the works. The most common agency relationship in the business is those between shareholders and managers and stockholder and debt holder. Besides Jensen and Meckling, McColgan (2001) also gave his opinions on agency theory. The main concern of his research was to figure out the area where the interests of shareholders diverge from those of the interests of managers.

Performance measurement is defined as a method that measures the efficiency and effectiveness of an action (Neely et al., 1995). Besides that, performance measurement changes the complexity of performance into symbol that easy to understand by others (Lebas, 1995). Performance measurement therefore plays an important in the current business

environment in order to ensure the effectiveness of the corporations (Koufopoulos et al., 2008). In addition, firm value can be defined as profits originate from share of the firms by shareholders (Rouf, 2011). Furthermore, performance of the firm can be observed from the financial statement of that particular firm.

There are several measurements that can be used to evaluate the firm performance such as return on assets, return on equity, return on sale, return on investment, earning per share, profit margin and many more. However, return on equity (ROE) considered as one of the most commonly used measurement to evaluate firm performance. Generally, return on equity is calculated by using profit after tax divided by total equity shares. Return on equity is mainly for measuring profitability of a company by revealing what is the amount of profit a company can earn using the money invested by shareholders. Besides that, return on equity also reflects and focus on the shareholder wealth maximization.

They are many researchers evaluating firm performance using return on equity. For example, the authors state that there is a negative relationship between board size and return on equity (Al Manaseer, Al Hindawi, & Al Dahiyat, 2012). Besides that, the scholar found that the presence of outside directors will lead to higher ROE (Bozcuk, 2011). Moreover, some researchers such as Chiang and Lin also use ROE regression model to investigate the relationship between corporate governance and firm performance (Chiang & Lin, 2011). In the context of Ibrahim, the level of ROE is higher when the firm has more family ownership than non-family ownership (Ibrahim & Samad, 2011). In addition, study conducted by Rouf stated that CEO duality has positively correlate with return on equity (Rouf, 2011). On the other hand, the researcher investigated the relationship between board independence and firm performance. The results show that the board independence has a significant relation with return on equity (Heenetigala, 2011). Next, some of the researchers also test on the corporate governance and firm performance using return on equity such as Yasser. As a consequence, they reveal the result that board size has positively associated with ROE (Yasser et al., 2011).

### **Methodology**

There are past researches stating that board size considered as an important corporate governance mechanism that affect firm performance. CEO duality is seen to be connecting with performance of the firm. Moreover, the presence of independent directors is said to be related to firm performance. The last factor in the literature review mentioned that compensation has a significant relationship with firm performance. Research framework is then developed to implement the study using those factors stated above.

According to Figure 1, the independent variables consist of size of the boards, CEO duality, the presence of the independent directors and compensation whereas firm performance will be the dependent variables in this framework. The purpose of this research is to identify whether there is a relationship between independent variable and dependent variable.

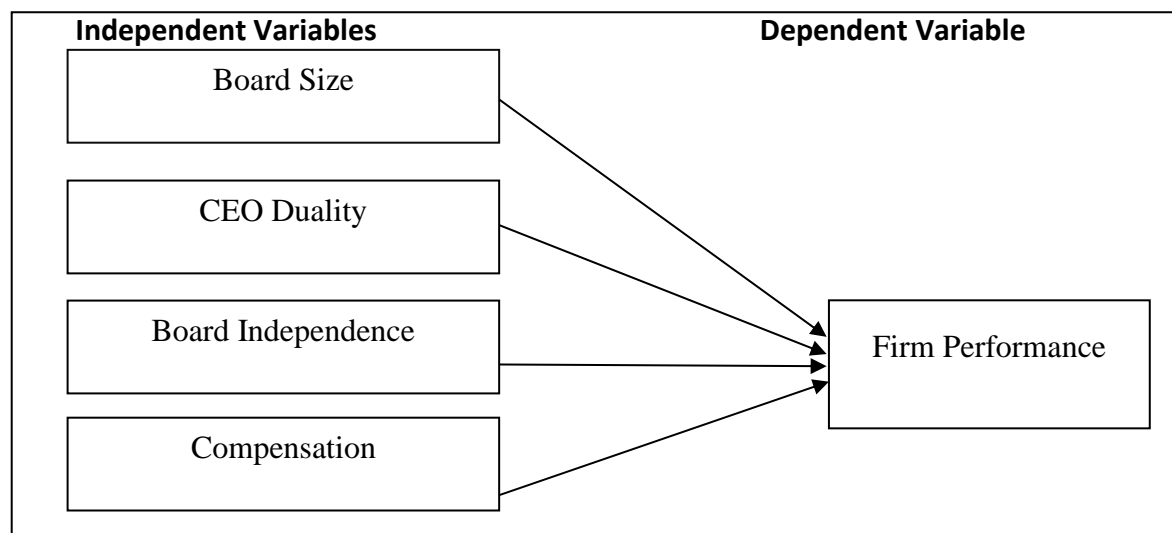


Figure 1: Research Framework

Table 1

*Measurement of the Variables*

Variables	Terms of Measurement	Source
Independent variable		
Board Size	Total number of the directors on the board. (A number of boards of ten to fourteen are considered as optimum)	(Martin, 2015)
Independent Directors	The total number of outside directors on board	(Shakir, 2008)
CEO Duality	Duality-coded as 1 Without duality-coded as 0	(Gill & Mathur, 2011)
Compensation	Average compensation of all directors on the board	(Vo & Phan, 2013)
Dependent Variable		
Firm Performance	Return on Equity = Profit after tax / Total equity shares	(Singh & Gaur, 2009)

This research involved a sampling of 100 top listed companies in Malaysia which chosen based on market capitalization. There are some reasons for selecting these 100 listed companies. The first reason is those top 100 listed companies considered as the market leaders thus they are able to fulfill the requirement that needed and have large operation to strengthen the firm performance. The second reason is the sample that selected in this study cover the area of 100 listed companies with various industries and sectors.

In general, this study is based on the annual reports of listed companies in order to gather the quantitative data and information required to measure the all the independent and dependent variables. These annual reports can be downloaded or retrieved from the official website of Bursa Malaysia. The data and information required to conduct this study is

collected from year 2013 to 2015 annual reports on Bursa Malaysia after the establishment of Malaysian Code on Corporate Governance 2012 (MCCG, 2012). The MCCG 2012 is mainly concentrate on clarifying the roles and responsibilities of the directors and board structure. The data of year 2013 to 2015 are selected because they are considered far away from the establishment of MCCG 2012 which assumed to provide better understanding on the effect of corporate governance on performance of firm.

The data and information of the study will be analyzed using the Statistical Package for the Social Sciences (SPSS) computer program. The analysis consists of descriptive statistic, normality test, correlation analysis, multicollinearity analysis and regression analysis.

### Results and Discussions

A sample was collected from 100 listed companies on Bursa Malaysia for the period of year 2013 to 2015. This sample did not include banks due to significant difference of the capital structure. Besides that, the format of financial statement of these 100 listed companies is different thus missing data are unavoidable. Those firms that have missing data also excluded from the sample of the study. Therefore, the final sample only includes 85 companies with 226 observations.

Descriptive statistics is used to describe and summarize the characteristics of the sample. Tables presented below show the descriptive results for all variables utilized in this study based on the annual report for the period of year 2013 to 2015. All the tables below showed the minimum, maximum, mean and standard deviation.

Table 2  
*Descriptive analysis*

<i>Variable</i>	<i>Minimum</i>	<i>Maximum</i>	<i>Mean</i>	<i>S.D.</i>
<i>N=226</i>				
BSIZE	5	14	8.92	1.906
BINDEPEN	2	8	4.10	1.125
CEODUAL	0	1	0.07	0.249
BCOMPEN	6788	15932750	1444778.95	1942765.755
ROE	-3.01	34.27	11.6520	6.26309

*Note:* BSIZE=Number of director on board; BINDEPEN= Board Independence; CEODUAL=CEO duality; BCOMPEN=Board Compensation; ROE= Return on Equity.

Table 2 presents the descriptive statistics for all variables in this study for 85 listed companies. First of all, it shows that the board size ranged between five and fourteen for the listed companies. The results described that as the minimum number of directors sit on listed companies in Malaysia is five members and the maximum number is fourteen persons. The average board size in this study is 8.92. Based on the result, the average number of directors sit on the listed company board in Malaysia is nine. The standard deviation of board size is 1.906.

Table 3

*Kolmogorov-Smirnov Test*

Variables	Kolmogorov-Smirnov <sup>a</sup>
	Sig.
Size of board	0.000
Board independence	0.000
CEO duality	0.000
Board compensation	0.000
Return on equity	0.001

Table 3 above indicates the result from the Kolmogorov-Smirnov test. From the normality test, all variables have significant level of less than 0.05. Therefore, it can be concluded that the data in this study is not normally distributed. However, Pallant stated that the normality test is not significant when comes to large sample size and he argued that for a sample size of not less than 30, any violation on its normality should not have any problem (Pallant, 2001). Besides that, Vaus also argued that a parametric statistic is acceptable to be used for non-normal distributed data when the samples are large which is 100 and more (Vaus, 2002). Other than that, according to the 'central limit theorem', when sample is large, the sampling distribution will take the shape of a normal distribution regardless of the shape of the population from which the sample was drawn (Field, 2009). The sample size of this study is 226 observations and it is considered as large sample size. As mentioned earlier, the normality assumption can be omitted when the simple size is larger than 200 thus the data can be assumed as normally distributed.

Table 4

*Multicollinearity Test Results of All the Independent Variables*

Variables	Tolerance Value	Variation Inflation Factor (VIF)
Constant		
Board Size	0.687	1.456
Board Independence	0.725	1.380
CEO Duality	0.914	1.094
Board Compensation	0.955	1.047

Multicollinearity means the relationships between independent variables were also tested where its presence could violate the use of regression analysis. Multicollinearity is a scenario in which the independent variables are highly correlated between each other. Table 4 showed the multicollinearity test results for all the independent variables of the study. Besides that, multicollinearity was tested in the context of tolerance values and variance and variance inflation factor (VIF) coefficients. According to (Pallant, 2007), if the tolerance value is more than 0.10, it indicates that there is no multicollinearity problem. Therefore, the common threshold level recommended for the tolerance value is 0.10. Based on the figures

presented in table above, the tolerance values for all the independent variables were found to be above 0.10. Therefore, the variables have no multicollinearity problem.

Another alternative way to test the presence of multicollinearity among variables is using the variance inflation factor (VIF) coefficients. Pallant stated that there is no multicollinearity problem if the VIF values do not exceed 10 (Pallant, 2007). Based on table 4, the VIF values presented for board size, board independence, CEO duality and board compensation are 1.456, 1.380, 1.094 and 1.047 the entire coefficient values are less than 10 which prove that the study have not violated the multicollinearity assumption.

Table 5

*Pearson's Correlation s Coefficient Matrix*

	<b>ROE</b>	<b>BSIZE</b>	<b>BINDEPEN</b>	<b>CEODUAL</b>	<b>BCOMPEN</b>
<b>ROE</b>	1.000	0.124	0.166*	-0.106	0.048
<b>BSIZE</b>		1.000	0.497**	-0.214**	0.079
<b>BINDEPEN</b>			1.000	0.007	-0.065
<b>CEODUAL</b>				1.000	0.118
<b>BCOMPEN</b>					1.000

\*. Correlation is significant at the 0.05 level (2-tailed).

\*\*. Correlation is significant at the 0.01 level (2-tailed).

*Note:* BSIZE=Number of director on board; BINDEPEN= Board Independence; CEODUAL=CEO duality; BCOMPEN=Board Compensation; ROE= Return on Equity.

The correlations analysis is used to test the association between dependent and independent variables (Hair et al., 2006). It is measured by correlation coefficient to test how strong the relationship is. Correlation tests were then used to measure whether independent such as board size, board independence, compensation and CEO duality are interrelated to dependent variable such as firm performance.

Table 5 present the correlation analysis and the results show that the ROE is significantly positive correlated with board independence at 0.166. On the other hand, other independent variables such as CEO duality, board compensation and board size are found not to be significantly correlated with the ROE. The highest correlation is between board size and board independence i.e. 0.497, which indicate that multicollinearity is not a serious problem. Board compensation and board size have positively correlated with ROE while CEO duality has negatively correlated with ROE. Based on the analysis that was performed on the data set, it can be concluded that the assumptions of multicollinearity were generally not violated.

Table 6  
*Model Summary*

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.210 <sup>a</sup>	<b>.044</b>	.027	6.17843

a. Predictors: (Constant), BSIZE, BINDEPEN, CEODUAL, BCOMPEN

Based on table 6, it showed that the R<sup>2</sup> is 4.4 % variance. As presented in the table, this means that all the independent variables such as board size, board independence, CEO duality and board compensation explain an additional 4.4% of the variance in firm performance while the remaining 95.6% have other factors to explain. Therefore, it suggests that another 95.6% of others factor or variables which might explain the firm performance better than what been used in this study.

Table 7  
*Anova Table*

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	389.683	4	97.421	2.552	.040 <sup>b</sup>
	Residual	8436.225	221	38.173		
	Total	8825.907	225			

a. Dependent Variable: ROE (return on equity)

b. Predictors: (Constant), BSIZE, BINDEPEN, CEODUAL, BCOMPEN

Based on table 7 above, the F-value for the data is 2.552 and the p-value is 0.040 which is less than 0.05 ( $p < 0.05$ ). In other words, it means that independent variables in this study are significant to measure the dependent variable and at least one of the variables is significant in this study.

Table 1  
*Coefficients Table*

Model		Unstandardized Coefficients		Standardized Coefficients		Sig.
		B	Std. Error	Beta	t	
1	(Constant)	7.378	2.214		3.473	.001
	BSIZE	.041	.261	.012	.156	.876
	BINDEPEN	.919	.430	.165	2.136	.034
	CEODUAL	- 2.824	1.727	-.112	-1.635	.103
	BCOMPEN	2.289	.000	.071	1.055	.292

a. Dependent Variable: ROE

From the table, focusing on the p-value column, there are only one variable that make a statistically significant contribution (less than .05) which is board independence with the p value of 0.034 whereas other independent variables are not significant.

Board independence has a greater  $\beta$  value of 0.165 than other independent variables. Based on the  $\beta$  value, the board independence has greatest influences as compare to other



independent variables such as board size (Beta value: 0.012), CEO duality (Beta value: -0.112) and board compensation (Beta value: 0.071).

### **Conclusion**

Based on the finding, only board independence has a significant positive relationship with firm performance. In which, the higher level of independence of the board, the better performance that the firm might archive. Therefore, it concludes that in this research, corporate governance mechanism choose is not the main indicator to the performance of the firm. As presented in R square above which only 4.4% presented by the variable choose in this research. Future research should include other possible variable to increase the level of influences towards firm performances. More relevance corporate governance mechanisms will become more relevance predictor for firm performance. Therefore, the firm might used this information to predict what is the best mechanisms to be implemented in their company to archive better firm performances.

### **Limitation of the Study**

Firstly, the sample used in this study only include top 100 listed companies selected according to the list of market capitalization produced by Bursa Malaysia. Besides that, this study only included the data from annual report 2013 to 2015. Therefore, it can lead to inaccurate of the results during the research. Thirdly, the research is only conducted in Malaysia. Therefore, the information may be demographically bias. Next, the research only conducted in limited time, so the information that found is limited and not detail.

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