

## The Role of Internal and External Corporate Governance Mechanisms on Firm's Financial Performance in Malaysia

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### ABSTRACT

*This paper examined six corporate governance variables which are hypothesized to have an influence on firm's financial performance in Malaysia. The variables encompassed four internal monitoring measures (CEO and chairman of the board, non-executive directors, audit committee and concentrated ownership) with the remaining two variables being external measures (institutional investors and lenders). An empirical study was conducted based on data involving 420 Malaysian listed companies over a four-year period from 2009 to 2012. A combination of cross-sectional and time-series data was employed in the analysis. An econometric model using panel data regression techniques was employed to analyse performance of the firms using both fixed effects and random effects models. Using return on equity as the dependent variable, it was established that CEO duality (an internal monitoring measure) significantly influences the performance of firms. The study showed that a CEO who is also chairman of the board exerts a positive influence on company earnings. It suggests that CEO duality could increase performance of firms when these CEOs dominate the decision-making process in their companies. None of the other monitoring measures relating to independent directors, institutional investors, ownership structures, audit committee and banks played any role in influencing firm performance.*

*Keywords: CEO duality; corporate governance; board practices; independent directors; institutional investors; ownership structures; audit committee; firm performance*

### INTRODUCTION

The focus on corporate governance has risen dramatically over the last two decades. This is due to a host of high-profile corporate scandals that have shaken up the corporate world, the most recent ones being related to the global financial crisis (e.g. Bear Stearns, Lehman Brothers). These corporate collapses have put a greater emphasis on the importance of good corporate governance; the painful consequences are highly visible to the general public. In Asia, poor governance standards in both corporate entities and government were partly blamed for the East Asian financial crisis. In Asia, corporations tend to follow the 'insider' model with dominant control by owners and large shareholders (Sycip 1998; Yamazawa 1998). The erosion of investors' confidence has been identified as one of the major factors that exacerbated the financial turmoil in Malaysia and a number of Asian countries. Many commentators, for example, Noordin (1999) argued that the erosion of investors' confidence in Malaysia is brought upon by the country's poor corporate governance standards and lack of transparency in the financial system.

The paper examined whether certain corporate governance variables have an impact on firm performance. Six corporate structures and practices were examined to determine if they have any effect on a company's performance. There are four internal monitoring mechanisms, namely; the CEO duality issue, the

governance role of independent directors, concentrated ownership structure, and governance role of audit committees; and two external monitoring mechanisms (governance role of institutional investors and lenders in corporate governance). The paper concludes with a discussion of some theoretical and practical implications from the results of an empirical study of governance structures in Malaysia.

### MOTIVATION OF THE STUDY AND ITS CONTRIBUTION

The objective of the study was to find out if certain corporate governance practises can contribute significantly to firm performance. An econometric model was used in identifying and analysing variables that can affect a firm's profitability. The findings of this study provides empirical evidence lending support to the espousal of good corporate governance practises as prescribed by the Cadbury Committee (1992) and subsequent revisions. There are theoretical and practical implications arising from this study and its finding adds on to the existing body of knowledge on corporate governance practises in Malaysia.

Another contribution is that this paper examined the guidelines on CEO duality as stipulated by the Malaysian Code on Corporate Governance (revised 2012). It also discussed its relevance to the situation in Malaysia; bearing in mind that the Malaysian code draws heavily on UK experience.

## LITERATURE REVIEW

### THE CEO DUALITY ISSUE

In Great Britain, more than 70% of the major British public companies do not have a duality structure, i.e. the chairperson is not the CEO (Lorsch and Lipton 1993). In these British companies, a non-executive outside director is the chairperson. The chairperson sets the agenda for the board and presides at the meetings of the board and of shareholders. Frequently, the chairperson speaks for the company while the CEO manages the company.

In the United States, the opposite approach prevails. Less than 20% of U.S. companies have a separate chairperson and CEO. The vast majority of U.S. chief executives opposed the separation of the two roles on the grounds that: (1) it would dilute their power to provide effective leadership of the company; (2) it creates the potential for rivalry between the chairperson and the CEO, leading to compromise rather than decisiveness; (3) the chairperson may be overly protective of the CEO and shield the CEO from being held accountable by the board for poor performance; and (4) having two public spokespersons leads to confusion and the opportunity for third parties to take advantage of the division. In many US companies, strong CEO defines ethical values of the firm and becomes the framework of corporate governance on which the board acts (Patnaik & Sahoo 2010).

In Malaysia, the number of companies with role duality had increased from 17% in 1996 to 30% in 2000, and the mean for the five-year period was 26%, indicating that role duality is not common in Malaysian companies (Haniffa & Hudaib 2006).

The issue of whether or not the roles of Chief Executive Officer (CEO) and Chairman of the board of directors should reside in one person has been addressed from two contrasting perspectives (Dalton, Daily, Ellstrand, & Johnson 1998). Proponents of CEO duality generally draw upon stewardship theory to substantiate their claim in favour of the joint structure. It is argued that such unified firm leadership will facilitate superior firm performance as it removes any internal or external ambiguity concerning who is responsible for firm's processes and outcomes, eliminates the possibility of dysfunctional conflict and power struggles between the CEO and board Chair, and avoids having two public spokespersons addressing stakeholders (Conger & Lawler 2009; Dalton, Daily, Ellstrand & Johnson 1998). However, while CEO duality is a common phenomenon in companies, its desirability is often questioned. Emanating from the agency theory, CEO duality has often been considered problematic since the CEO simultaneously acts as the Chairman of the board, resulting in a situation where it is very difficult for the board of directors to properly monitor the top management's performance and to operate independently. The risk of managerial dominance of the board and the firm is thus argued to be mitigated by the separation of both positions (Conger & Lawler 2009).

There is evidence to suggest that leaders matter most when ownership and governance structures correspond with a weak or ambiguous institutional logic (Clark, Murphy & Singer 2014). Their study contributes new insight into the 'opportunity structure' of CEO influence, that is, the organisational factors that shape leader discretion; and, hence, the CEO's level of influence over firm performance.

### THE ROLE OF LENDERS IN CORPORATE GOVERNANCE

The role of lenders as a force in corporate governance has not yet been extensively analyzed (Prigge 1998). Lenders are interested in the repayment of a credit in accordance to the credit contract. Since management's actions are one of the factors determining repayment, lenders may be motivated to carry out monitoring. Billimoria (1997) found evidence to indicate that CEOs of highly leveraged firms have less long-term pay. Using three criteria, namely total voting power at the general meeting, chairmanship on the supervisory board, and liabilities owed to banks (data from 1990-1992), Perlitz and Seger (1994) segregated a sample of 110 listed industry companies into one group in which banks have a great potential influence (58 companies) and one group in which banks only have a small potential influence (52 companies). They found a significant difference between both categories: companies of the first group show a significantly lower profitability and growth; suggesting that bank influences lead companies to take less risk and therefore performed poorly. In this study, the governance role of banks has been negative.

On the other hand, Cable (1985) and Nibler (1995) discovered a positive relationship. Cable (1985) found a positive relationship between bankers' supervisory board membership and company performance. On the other hand, Chirinko and Elston (1996), using the same criterion for potential bank influence, did not find a relation. However, a Malaysian study by Borhanuddin and Pok (2011) found a significant relationship between cash holdings and leverage; suggesting that companies with good corporate governance normally hold cash at much lower level than companies that have poor governance structures. Overall, these studies gave mixed results and did not clearly indicate that bankers can perform a value-enhancing role.

### THE GOVERNANCE ROLE OF NON-EXECUTIVE DIRECTORS

In Malaysia, studies by Abidin, Kamal and Jusoff (2009) and Ramli, Nawawi and Ameer (2010) found a positive correlation between board composition and firm performance. A study by Ramli et al. (2010) suggested that a critical mass of outside directors is crucial to achieve board independence, thus improving firm performance. However, another Malaysian study by Haniffa and Hudaib (2006) found otherwise; suggesting that boards dominated by non-executive directors have no effect on firm performance.

Byrd and Hickman (1992) reported that bidders of tender offers with majority-independent boards earned

roughly zero stock price returns on average, while bidders without such boards suffered statistically significant losses of 1.8% on average. You, Caves, Smith & Henry (1986) also reported a significant negative correlation between proportion of inside directors and bidder stock price returns. This suggests that independent directors may help to restrain the CEO's tendency to build a larger empire, even if this means overpaying to buy another company. Denis and Sarin (1997) reported that firms that substantially increased the proportion of independent directors had above-average stock price returns in the previous year. In a study to assess investor reaction to the appointment of additional directors, Rosenstein & Wyatt (1990) found that stock prices increased by about 0.2% on average, when companies appointed additional outside directors. This increase is statistically significant, but economically small.

#### THE GOVERNANCE ROLE OF INSTITUTIONAL INVESTORS

Large outside (institutional) shareholders are regarded as an effective monitoring mechanism since they have a vested interest in minimizing any asymmetry of information which may exist and will therefore vote in accordance to their own interests (Jarrell & Poulson 1987). In addition to the monitoring role, Shleifer and Vishny (1986) also argued that large outside shareholders assist the market for corporate control simply by being willing to sell their shares should an appropriate bid be made. They, therefore have an incentive to monitor the behavior of managers which should solve the free-rider problem identified by Grossman and Hart (1980).

A Malaysian study by Wahab, How and Verhoeven (2008) suggested a positive and significant relationship between institutional ownership and corporate governance, i.e. an improvement in corporate governance leads to an increase in institutional ownership. The positive effect of institutional investors is that it can lead to an increase in the company's share price. Institutional investors are professionals who put a premium value on companies with good corporate governance practices.

#### THE CONCENTRATED OWNERSHIP STRUCTURE

In regard to the relationship between ownership concentration and firm performance, empirical results in the U.S. are inconclusive. Demsetz and Lehn (1985) found no significant correlation between ownership concentration and profit rates for 511 large corporations. Morck, Shleifer and Vishny (1988) reported a piecewise linear relationship of Tobin's Q with board member ownership for 371 Fortune 500 firms, and also found evidence of an inverted "U"-shaped relationship between the degree of ownership concentration and profitability. The study suggested that there is an optimal level of ownership; and that high concentration of ownership is counter-productive to achieve better performance. Stulz (1988) demonstrated that high managerial ownership can insulate managers from external takeover, and by allowing managers to block

takeover bids, firm value could be lower. Using U.S. data, Morck et al. (1988), McConnell and Servaes (1990, 1995), Hermalin and Weisbach (1991), and Holderness, Kroszner and Sheehan (1999) found that firm value raises with low level of managerial ownership and fall with high level of managerial ownership.

In Malaysia, ownership structures as represented by directors, foreign and government ownership have no impact on corporate performance (Ghazali 2010; Abidin, Kamal & Jusoff 2009). However, another Malaysia study by Tam and Tan (2007) found otherwise; their study suggested that types of ownership have a direct impact on firm performance. They also argued that Malaysia's financial system fails to provide adequate signalling effect; and therefore, could not provide effective monitoring role over management.

#### THE GOVERNANCE ROLE OF AUDIT COMMITTEES

Several empirical studies on the impact of audit committees on firm value gave mixed results. A study by Aldamen, Duncan, Kelly, McNamara, and Nagel (2011) found that during the recent global financial crisis, financial expertise and external directorships of audit committees were positively associated with firm performance. However, Brick and Chidambaran (2010) recorded a negative impact of the monitoring activity of audit committees on firm value for the sample as a whole. Another study by Henry (2008) indicated that internal governance factors (i.e. the existence of an audit committee) do not substantially impact firm value.

Several studies documented that the presence of an audit committee is associated with fewer incidences of financial reporting problems. A study by Sun, Wei, and Xu (2012) found that accounting, finance and insurance financial expertise in audit committees are associated with more accurate loss reserve estimates. Similarly, Lary and Taylor found that audit committees independence and financial expertise are significantly related to a lower incidence of financial re-statements (i.e. the annual reports are more accurate). Also, a study by Lo et al. (2010) showed that firms with high board independence and financial experts on their audit committees are less likely to engage in transfer pricing manipulations.

#### MONITORING MEASURES AND HYPOTHESES FORMULATION

Six measures of monitoring were used in this study; and divided into two types: internal or external monitoring measures. Consequently, hypotheses were formulated to examine the two types of monitoring measures.

#### INTERNAL MONITORING MEASURES

The first internal monitoring measure is the ratio of the number of outside (non-executive) directors to total directors (i.e. inside and outside directors), a measure commonly used by researchers to measure corporate control (e.g. Morck, Shleifer & Vishny 1988; Weisbach

1988; Beatty & Zajac 1994). The second internal monitoring measure is the dichotomous CEO/chairman variable, indicating whether the CEO position is separated from the chairman of the board. The third internal monitoring measure is the presence of an independent audit committee which is expected to provide advice and monitor firm performance. The fourth monitoring measure is the presence of concentrated ownership which by virtue of their large shareholdings will increase their monitoring as their proportion of share capital increases. Therefore, it is hypothesized that:

- H<sub>1a</sub>: a firm's financial performance will be positively related to the representation of non-executive directors on the board.
- H<sub>1b</sub>: a firm's financial performance will be positively related to a strong leadership structure (CEO duality).
- H<sub>1c</sub>: a firm's financial performance will be positively related to the presence of an independent audit committee chairman.
- H<sub>1d</sub>: a firm's financial performance will be positively related to the presence of large shareholders.

#### EXTERNAL MONITORING MEASURES

The first external monitoring measure is the presence of large creditors, i.e. bank debt. Banks are expected to use their influence as lenders to monitor management in order to ensure repayment of their principal and interest in the future. The second monitoring measure is the presence of a shareholder with large equity holdings (greater than 5%) that is not on the board (i.e. a blockholder or institutional investors). Therefore, it is hypothesized that:

- H<sub>2a</sub>: a firm's financial performance will be positively related to the presence of large creditors (banks).
- H<sub>2b</sub>: a firm's financial performance will be positively related to the presence of institutional investors.

#### METHODS AND PROCEDURES

The data for this study were gathered from 420 Malaysian public listed companies during the period from 2009 to 2012. The period was chosen because complete data were not available after that period. The samples were public companies fully quoted either on the main board or the ACE board of the Malaysia Bourse (Stock Exchange). A large majority of the companies selected (87%) comes from the main board. The samples covered all sectors of the economy. The samples were drawn from twenty volumes of the Malaysia Bourse (*On Disc*) CD-ROM on the basis that only companies reporting their four years of financial results and disclosing the pertinent corporate governance data were selected for this research. The sample selected is line with other previous researches on this area, e.g. Yeboah-Duah (1993) studied a sample of 210 Malaysian firms for the period 1984-1991, Mat-Nor, Said and Redzuan (1999) used 79 Malaysian firms, Ruhani and

Sanda (2001) used 112 Malaysian listed firms covering the period 1992-1997, Yap (2001) used 69 companies covering the period 1995-1999 and Haniffa and Hudaib (2006) used 410 companies, Ghazali (2010) used 87 non-financial listed companies and Fooladi, Shukor, Saleh and Jaffar (2014) used 400 listed companies. These studies suggest that difficulties in obtaining complete data from listed companies constrained the inclusion of all companies in the stock exchange. Therefore, the sample chosen does not only depend on the type of study undertaken, but also the timely disclosure of information by these companies.

#### DEPENDENT VARIABLE

This research utilized the commonly used accounting measure of performance of public listed companies (PLCs) as the dependent variable, namely return on equity (ROE). ROE is defined as earnings divided by total ordinary shareholders' fund. The dependent variable is used as proxy for firm performance. A high score for the variable signifies favourable financial performance.

#### INDEPENDENT VARIABLES

The independent variables are factors that may influence firm performance, and they could potentially have an impact on the return on equity (ROE) either positively or negatively. Five (5) independent variables were selected. They are represented by:

1. NED - measures the proportion of non-executive directors on the board of directors, expressed as a percentage. It is defined as the number of non-executive directors divided by the total number of directors on the board of the company. The coefficient's expected sign is positive, i.e. the higher the proportion, the more independent the board is in making decisions. This implies better company performance, measured by return on equity ratio.
2. CHAIRAC - a binary variable. If the chairman of the audit committee is a non-executive director, it is coded one, otherwise zero. This serves to test the degree of independence of the audit committee. A non-executive chairman is expected to contribute to a more rigorous regime of monitoring and therefore improves performance of the company.
3. CEOCHAR - a binary variable. If the positions of the chief executive officer (CEO) and the chairman of the board are filled by a single person, the variable has the value of one, and zero if they are not. The coefficient's expected sign is positive. This is because a unity of command structure can motivate the CEO to strive for excellent performance.
4. INST - measures the proportion of large institutional investors. The higher the proportion, the greater is the monitoring role of institutional investors. It also implies that managers of companies would be under pressure to perform to the expectations of institutional investors. The coefficient is expected to be positive.

5. GEAR - measures the proportion of large borrowings. It is a gearing ratio and is defined as long-term borrowings/debt divided by total shareholders ordinary fund plus long-term debt. The coefficient is expected to be positive since greater borrowing implies that lender/bank will be expected to play a greater monitoring role.
6. CONCEN - measures the proportion of concentrated ownership. The higher the proportion, the greater the monitoring role of large owners. This is in line with agency theory which hypothesizes that greater ownership would reduce agency costs and hence improves performance. The coefficient is expected to be positive.
7. SIZE - captures the size of the company in terms of turnover. Size is expected to be a positive influence on company performance due to greater diversification, economies of large scale production and greater access to new technology and cheaper sources of funds. The coefficient is expected to be positive.

#### MODEL SPECIFICATION

Most of the literature used univariate and multivariate logistic regression analyses, or multiple linear regressions to test firm's value and ownership (Weir 1997). The method used in this analysis was the pooled ordinary least squares (OLS), applying cross sectional time series standard multiple regressions. The econometric model formulated is based on return on equity (ROE) as the dependent variable. H1 and H2 were tested using the following OLS model. The model is formulated as follows:

$$ROE_t = \beta_1 + \beta_2 NED_{t-1} + \beta_3 CHAIRAC_{t-1} + \beta_4 CEOCHAR_{t-1} + \beta_5 INST_{t-1} + \beta_6 GEAR_{t-1} + \beta_7 CONCEN_{t-1} + \beta_8 LogSIZE_{t-1} + e_i$$

Where;

- ROE = Return on Equity ratio  
 NED = Non-Executive Directors  
 CHAIRAC = Chairman of the Audit Committee  
 CEOCHAR = Chief Executive Officer and Chairman of the Board  
 INST = Institutional investors  
 GEAR = Gearing ratio  
 CONCEN = Concentrated Ownership  
 LogSIZE = Logarithm of Size of Firm  
 $e_i$  = error term

#### PANEL DATA REGRESSION ANALYSIS

The ordinary least squares (OLS) regression that was done earlier produced relatively low  $R^2$  value and low Durbin-Watson statistics. An examination of the F-test and its P-value clearly indicate that the OLS method is not appropriate (Leamer, 1978). This is because the data under study is panel data or sometimes referred as pooled data and it is consisted of a combination of time series and

cross-sectional data. Such data require the use of panel data regression models in order to obtain meaningful results. There are two most frequently used estimation techniques to address these problems, namely the fixed effects model and the random effects model (Gujarati 2003). Both models form part of the generalized least squares (GLS) method of analysis.

The data was analyzed by the econometric software, Time Series Processor (TSP) version 5. This is one of the few software that has the capability of handling panel data since the data collected were massive. Only the dependent variable is expressed in natural logarithm form. This study used panel data as the basis of an empirical analysis to determine the complex relationship between corporate governance structures and firm performance. Such analysis, employing cross sectional and time series data generates a large data set that requires new techniques or models.

The advantages of panel data methods, as compared to standard estimation techniques include increased precision of regression estimates, the ability to control for individual effects and to model temporal effects without aggregation bias (Greene 2000; Baltagi 2001). The underlying assumption is that first order serial correlation is addressed by using multiple regression techniques (Yermack 1996; Boyd 1995). For this model, diagnostic analyses were conducted to check the presence of multicollinearity and heteroscedasticity. The variance inflation factors for the model ranged from 0.998 to 3.89, i.e. below the threshold of 10, suggesting that multicollinearity is not an issue (Gujarati 2003; Hair et al. 2006).

#### RESULTS AND DISCUSSION

##### DESCRIPTIVE ANALYSIS

The results in Table 1 show that a majority (87%) of companies came from the main board while the ACE (second) board comprises 13%. These findings are consistent with other Malaysian studies (Ibrahim & Abdul Samad 2010; Amran & Ahmad 2013). The vast majority of public companies in Malaysia are quoted on the main board since they are large companies and benefited from higher market liquidity as compared with the less traded second board. It is more prestigious to be quoted on the main board as investors prefer bigger, blue chip companies that are well managed.

TABLE 1. Frequency and percentage of companies by type of board

|                    | Frequency | Percentage |
|--------------------|-----------|------------|
| Main board         | 365       | 87         |
| ACE (Second) board | 55        | 13         |
| Total              | 420       | 100        |



LM heteroscedasticity test (0.998) indicated the absence of significant heteroscedasticity.

Table 4 shows that the findings partially support hypothesis H1 but not H2. In fact, hypothesis H2a was significant but in the opposite direction to the prediction.

The results show that non-executive directors (H1a) did not perform as predicted by the hypothesis. It was found that non-executive directors in Malaysia had no influence on returns, i.e. profitability of the company. It seems that these non-executive directors were not independent enough to play a serious monitoring role, and the results indicated that they may not be of high calibre to contribute significantly to firm performance. The results also indicate that even if the non-executive directors were a majority on the board, they had not significantly influenced ROE, signifying the lack of independence which is expected of them (Chang, 2008). The presence of non-executive directors was merely likely to fulfil the requirements of the Malaysian Code on corporate governance and this finding is similar to a study by Amran and Ahmad (2011).

In terms of leadership structure (H1b), it was found that CEO duality performed as predicted by the hypothesis and this finding is similar to that of a Malaysian study by Amran and Ahmad (2011). The estimated coefficient for this variable (CEOCHAR) is 0.521. This is statistically significant at 5% level, and can be interpreted as: everything else constant, companies that have a dominant personality (who holds the dual positions of CEO and chairman of the board of directors), can improve return on equity by 68.37%\* i.e.  $(e^{0.521} - 1)$  compared to companies that do not combine the two positions. This percentage is derived mathematically from the formula  $(e^{0.521} - 1)$  in accordance with the interpretation rule when using an

econometric model. The results indicate that a dominant CEO who is also chairman of the board has significant influence over company earnings. Since the CEO dominates decisions made in the company, he/she is expected to work hard to improve earnings.

The presence of an independent chairman of audit committee (H1c) did not give the result predicted in the hypothesis. The results show that audit committees chairmen who were non-executive directors in these companies did not play a significant role in influencing ROE. The fact that the chairman of the audit committee is a non-executive director has no bearing on performance. The same holds also true even if the majority of the committee members are non-executive directors. The results are similar to the findings of Shamsheer and Zulkarnain (2001). This can be explained in terms of the committee's lack of independence and skill required from the members (Chang 2008).

It was found that large ownership (H1d) did not performed as predicted in the hypothesis. Concentrated ownership in these companies has no bearing on company performance and the argument that large blockholders align their interest with the company appears not to be true in Malaysia. This finding is similar to the results obtained by Faizah (2002) who investigated similar relationship on plantation companies listed in the KLSE. According to the agency theory, large blockholders solve the agency problems partially and reduce costs. However, since they have control rights, they maybe in a better position to expropriate company assets and exploit the interest of the minority. Therefore, the owner-managers may have worked hard to increase earnings but these earnings may be used to enrich themselves, resulting in the company's performance remaining unchanged.

TABLE 4. Results of the fixed effects model (FEM) regression analysis using the natural logarithm of return on equity (LROE) as the dependent variable

| Independent Variable                                                                                                                                                                    | Coefficient | T-statistic | P-value  |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------|-------------|----------|
| NED                                                                                                                                                                                     | -0.000      | -0.058      | 0.954    |
| CONCEN                                                                                                                                                                                  | -0.016      | -1.300      | 0.195    |
| SIZE                                                                                                                                                                                    | 0.00        | 1.503       | 0.134    |
| SIZESQUARED                                                                                                                                                                             | -0.000      | -1.934      | 0.054*   |
| INST                                                                                                                                                                                    | 0.013       | 1.070       | 0.286    |
| GEAR                                                                                                                                                                                    | -0.657      | -4.358      | 0.000*** |
| CHAIRAC                                                                                                                                                                                 | -0.236      | -0.617      | 0.538    |
| CEOCHAR                                                                                                                                                                                 | 0.521       | 2.185       | 0.030**  |
| R <sup>2</sup>                                                                                                                                                                          |             |             | 0.688*   |
| Adjusted R <sup>2</sup>                                                                                                                                                                 |             |             | 0.518*   |
| Probability level of significance of the LM heteroscedasticity test                                                                                                                     |             |             | 0.998    |
| Probability level of significance that the fixed effect model is <i>not superior</i> to the corresponding random effect model based on the Hausman specification test (null hypothesis) |             |             | 0.002*   |
| Durbin-Watson statistic                                                                                                                                                                 |             |             | 1.912    |

*Notes:*

\* denotes statistically significant variables at 10% level.

\*\* denotes statistically significant variables at 5% level.

\*\*\* denotes statistically significant variables at 1% level.

The three statistically significant variables are SIZESQUARED, GEAR and CEOCHAR. Assuming all other things constant, the optimum size of company at which returns to equity are maximised is \$7.727 million, based on turnover.

In terms of external monitoring by banks (H2a), the result was significant but in the opposite direction of the hypothesis's prediction. The resulting coefficient (of GEAR) is a negative 0.657. The parameter estimate is highly significant (at 0.000 level). It can be interpreted as: 1% increase in gearing leads to a 0.13% (0.657 by 0.20) decrease in return on equity, given that the mean GEAR is 0.20. Interpretation of the results was derived mathematically using the elasticity in the regression equation, i.e. the derived value is the coefficient estimate multiplied by the mean value of the independent variable. In this study, the mean value of GEAR was used.

In terms of external monitoring by institutional investors (H2b), the result did not support the hypothesis. It was found that institutional investors did not exert any influence on firm performance. The finding in this study had been expected as institutional investors in Malaysia are not generally known to be actively involved in shareholder activism in the companies they had invested (Wahab et al. 2008). The results indicated that institutional investors are not actively exerting their influence through their voting power. Most have short-term objectives. Its influence rests in its ability to exit *en masse* (i.e. exit the stock market by selling shares in large quantities) and such actions could result in a fall in share prices. It seems that the role of institutional investors may be limited to monitoring without intervention (Jarrell & Poulson 1987).

#### CONCLUSIONS AND POLICY IMPLICATIONS

There were major significant findings in this study and these findings have some policy implications. Out of the seven independent variables that were hypothesized to influence return on equity (ROE), three were found to have a significant impact on ROE. The three independent variables which were found to be significant are (1) the dominant role of the CEO and chairman of the board, (2) gearing (borrowing) and (3) size of company. The results of the latter two variables are expected and in accordance with the accounting and finance literature (Billimoria 1997; Borhanuddin & Pok 2011). It is expected that gearing or borrowing leads to lower profits for the company due to the burden of paying interest costs, and bigger companies have advantages in terms of economies of scale in their operations.

The existence of a dominant personality where the CEO is also the chairman of the board may have a positive effect on company performance in Malaysia. The results of the econometric analysis supported the stewardship theory and opposed the agency theory. Stewardship theory states that CEOs are good stewards of their companies and work hard to put company interests above their personal interests. Stewardship theory holds that a CEO is not an opportunist but essentially wants to do a good job, that is, to be a good steward to corporate assets (Barney 1990). A duality structure provides clear and consistent role expectations that empower senior management (Tricker 1994). In such a structure, power is concentrated on one person and there

is no room for doubt as to who has the authority over any matter. There is unity of direction and the organization will enjoy the benefits of strong command and control. On the other hand, agency theory insists that the CEO is not to be trusted at taking care of shareholders' interest; and therefore a separate chairman is needed to monitor the CEO's performance and the CEO is to be removed if he/she underperforms.

The results of this study did not resonate with the guidelines of the Malaysian Code on Corporate Governance (revised 2012). The guidelines discourage companies from combining the roles of chairman and CEO. Whilst there is theoretical support for this guideline, the results of this study do not support the Malaysian code that the role of CEO should be separated from the board chairman. The result of the study revealed that separating the two roles leads to inferior performance. The Malaysian code follows closely the UK Code on Corporate Governance and this is based on UK's experience as set out in the Cadbury Report (1992) and the Hampel's Committee Report on Corporate Governance (1997).

The results from the study indicated that when CEOs dominate the decision-making process in the company, they tend to work hard to improve firm performance. Dominant CEOs are a common phenomenon in a developing economy and the results of this study indicate that this could bring positive outcomes. Politically savvy CEOs can secure profitable government contracts (Noor Azizah & Halimah 2007; Gomez & Jomo 1999). This is in line with the findings of Clark, Murphy and Singer (2014) whereby leaders matter most when ownership and governance structures are weak and institutional logic is ambiguous.

The result of this study resonates with a Malaysian study by Lo, Ramayah, Hii and Songan (2010) and Mohd Ghazali (2014). Strong leadership gives effective direction giving staff confidence and drives commitment towards performance. Their study showed that if supervisors maintain a good relationship with subordinates, there is greater commitment in achieving organizational goals. Similar findings were recorded by Quigley and Hambrick (2014) whereby CEOs matter more than ever for U.S. companies. Strong CEOs define corporate governance and ethical values of the firm are the driving force behind the magical turnaround of Xerox (Patnaik & Sahoo 2010). In Xerox, the CEO had to make tough choices but focussed on a vision toward generating greater value for shareholders and succeeded by establishing sophisticated internal metrics for achieving it. In addition, the CEO created value for everyone by taking steps to raise customers' satisfaction; motivated employees with better remuneration, and contributed more to the communities in which it did its business.

The results relating to gearing (borrowing) can be explained as follows: an increase in borrowing burdens the companies with interest payments which are directly charged to the income statement, thus dampening profits. This explains the negative sign for the resulting coefficient. However, according to Perlitiz and Seger (1994), high borrowing encourages the banks and creditors to monitor



the company and therefore is expected to contribute to higher profits through investments in value enhancing projects. The results clearly indicate that this is not the case in Malaysia. This is consistent with studies showing that banks do not perform such a value-enhancing role (Billimoria 1997; Qian & Yeung 2015).

The significant result relating to size is another contribution to the Malaysian corporate literature; whereby it provides empirical evidence that company size is positively identified with earnings. However, the relationship is rather complex as it indicates a parabola shaped curve of size over earnings. This is interpreted as: the larger the company, the better the earnings, but when the company gets too large, earnings will begin to suffer. It was found that earnings are maximized at the turnover level of RM7, 727 million or about 58% of the maximum (turnover) size of RM13, 294 million. The study identified the optimum size for which companies can grow. Consequently, it proved that even though size matters when it comes to earnings, there is a limit, and a corporation which has become too large can suffer reduced earnings. This can be explained in terms of managers favoring empire building at the expense of the productivity of the company. It can also indicate the CEO's inability to exert control and his/her lack of technical expertise to run large enterprises. The current corporate trend in the USA and Europe is to focus on a company's core business and get rid of unrelated businesses of which top managers know very little about. The study provided evidence that Malaysian companies may have to follow such an example.

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