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Board Composition, CEO Duality and Firm Performance: Malaysian Plantation Sector

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ABSTRACT

This paper seeks to examine the roles of independent members on the board and CEO duality on firm performance in Malaysia. Data on 40 Malaysian plantation companies over 2007 and 2010 are used. The result shows that independent directors may not fully understand the operations of their firms since they might not be fully involved in business activities. The findings indicate that a dual leadership structure is more effective with larger board sizes and longer years of operation. In the context of Malaysian plantations, firms should balance their number of outsiders and adopt a CEO duality structure in order to be competitive in facing external threats.

JEL classification: G34

Keywords: Board composition, CEO duality, corporate governance, plantation industry, Malaysia

INTRODUCTION

Investors and other stakeholders in corporations have begun to discover the importance of good corporate governance practices in protecting their interests (Ehikioya, 2009). Before making any investment in a company, investors look into the governance practices of the company and the structure of the board of directors as good corporate governance can enhance a firm's performance and increase its access to outside capital (Abdullah, 2004). Poorly governed firms find it difficult to attract capital investment from investors for their business expansion. Such firms are likely to suffer higher bankruptcy risks, lower valuations, less profit and less investment return to shareholders (Kyereboah-Coleman & Biekpe, 2006). Board members of such firms have been criticised for the decrease in shareholders' wealth and the failure of the firms. These firms might be associated with fraud cases such as WorldCom and

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Enron (Uadiale, 2010), where the board of directors failed to be vigilant in exercising oversight ability by assigning control power to managers who pursue their self-interest and fail in their accountability to shareholders.

Although many research studies have been carried out in the area of corporate governance, there are confusing results with regards to the effect of CEO duality and board composition on firm performance. Many developing or emerging market countries are not obtaining full and effective corporate governance support from the private sector (Samada, 2010) as the enforcement capacities are not yet fully developed due to the legal and regulatory systems. Malaysia is no exception. Unlike developed countries, Malaysia's legal and regulatory system is not as well established nor as well regulated(Gregory & Simms, 1999). Therefore, the prior study findings might not be applicable in the Malaysian context.

An Overview of Corporate Governance in Malaysia

Corporate governance is always in operation but it lacks clear definition (Abidin & Ahmad, 2007). Corporate governance is also always used to explain the structures and processes used to direct and manage business activities (Mustapja & Ahamd, 2011). According to the agency theory, outside or independent directors are in a better position to monitor management as they are assumed to be independent members not employed by the firm such as are its managers. The separation of Chairperson and Chief Executive Officer (CEO) provides higher transparency and accountability to firm information and decisions (Kroll *et al*., 2008). In contrast, the stewardship theory proposes that the board of directors should be dominated by executives or insider members in order for effective decisions to be made. The CEO and chairman positions should be combined in order to strengthen the leadership of the company (Ramdani & Witteloostuijn, 2009).

In the 1990s, Malaysia began to reform its corporate governance in order to develop better governance in monitoring firms with the purpose of enhancing transparency and accountability for the management of companies. The Asian financial crisis of 1997/98 brought to Malaysian government's attention the fact of weak corporate governance, which was the primary factor behind the crisis (Zulkafli *et al*., 2006). In 2000, the government launched the Malaysian Code on Corporate Governance (MCCG), which was fully implemented in 2001 (Mustpha & Ahamd, 2011). The code was gradually enforced on public-listed firms in Bursa Malaysia.

However, MCCG was again revised by the Malaysia Securities Commission with more stringent international standards effective as of 1 October 2007 (Johari *et al.,* 2008). The code proposes that the board of directors of a company should include independent directors numbering at least one third of the total board and that there must be clear separation of duties between the chairman and the CEO. Firms

in which the roles of chairman and CEO are combined have to publicly announce the fact and explain the need for it in their annual report (Securities Commission, 2007).

In 2000, the Code of Malaysian Corporate Governance (MCCG) was first issued. However, many scholars claim that the existing governance mechanisms lackeffective control over managerial behaviour (Khoo, 2003). Most listed companies have disclosed their corporate governance information according to their own format (Rachagan, 2010). Besides, many studies also focus on large firms in developed countries with very few studies having been conducted in developing countries such as Malaysia (Muhamad e*t al.,* 2005), especially studies related to the plantation industry.

Board Composition and Firm Performance

Fama and Jensen (1983) state that the board of directors plays a vital role in corporate governance. There are two types of board of directors, namely, insiders and outsiders. Some prior studies suggest the board of directors should consist of independent members i.e. non-executive and outside directors (Johari *et al.,* 2008). It may help to reduce the agency problem by controlling and monitoring the opportunistic behaviour of management (Meckling, 1976 cited in Haniffa & Hudaib, 2006).

Dehaene *et al*. (2001) use 122 Belgian listed companies to test the link between governance mechanism (board independence and CEO duality) and firm performance (ROE and ROA). The result presented significant positive relationship between board independence and ROE, implying the higher the percentage of outside director, the better the performance. The study of Kyereboah-Coleman and Biekpe (2006) find an insignificantly negative link between outside directors, Tobin's Q and ROA. Ehikioya (2009) finds no association between board composition and performance. Weir *et al*., (2002) documents no significant association between independent board composition and accounting based measure of performance. Using Tobin's Q, the findings from Yermarch (1996) and Ehikioya (2009) indicate a significant relationship between board composition and performance.

Based on Bhagat and Black's (2002) findings, there was no relationship between non-executive director and Tobin's Q. Kajola (2008) shows that there is no relation between ROE and board composition, implying an insignificant impact of the boards of outside directors on the firms' financial performances. Agrawal and Knoeber (1996) point out that too many outsiders on the board will not help to increase firm performance due to political reasons. Moreover, Ibrahim and Samad (2011) find no significant link in proportion of independent directors to performance as measured by ROE and Tobin's Q. The weak link between outside directors and performance indicated that outside directors cannot enhance potential value to the firms (Rashid *et al*., 2010; Haniffa & Hudaib, 2006). To conclude, the prior studies'

findings on the impact of independent non-executives are mixed.

CEO Duality and Firm Performance

The CEO is a full-time employee who holds the responsibility for the daily running of the firm as well as for setting and implementing corporate strategies. The chairperson leads the board of directors to ensure that the board performs effectively and he holds the responsibility for monitoring and evaluating the performance of the executive directors, including the CEO. A dual position does not separate the positions of chairman and CEO (Petra, 2005). The CEO takes responsibilities as chairman such as setting meeting agenda, running meetings of the board and overseeing the processes of compensation. Obviously, a potential conflict of interest arises when there is CEO duality (Petra, 2005). Higgs (2002) suggests both roles should not be combined due to the fact that a dual position affects the firm performance adversely (Chen *et al.,* 2005).

Among others, Pi and Timme (1993) and Rechner and Dalton (1991) suggest that firms with a dual leadership structure have a higher ROE. Consistently, Dehaene *et al.* (2001) find a significant positive link between CEO duality and ROA. However, according to Ehikioya's (2009) study, the CEO duality has a significant adverse impact on performance, measured as ROA and Tobin's Q. Kyereboah-Coleman and Biekpe (2006) find a negative correlation between thedual position and Tobin's Q and ROA but both are insignificant. Ibrahim and Samad (2011) suggest that if different persons held the separate positions of CEO and Chairman as suggested by the MCCG (revised 20007), then the firm's performance would improve.

Moreover, Haniffa and Hudaib (2006) state that there is no relationship between CEO duality and performance as measured by Tobin's Q while it is significantly inversely related to ROA. Kajola's (2008) study finds that there is a significant relationship between ROE and CEO duality but there is no relation between ROE and board composition. This is supported by Baliga *et al.* (1996) who also find no significant relationship between duality and firm performance. To conclude, the results of prior studies are inconsistent and mixed.

DATA AND METHODOLOGY

Data

The plantation industry was selected as the research context because it makes a substantial contribution to economic growth under the Malaysian Economic Transformation Programme (ETP) (Tan, 2011). Malaysia's palm oil export is one of the largest contributors to the Malaysian economy today, amounting to RM1.889 (8 %) of the country's GNI per capital (PEMANDU, 2010). The rubber industry, on the other hand, only contributed RM18.5 billion to the country's GNI in 2009;it is the second main commodity crop after oil palm (PEMANDU, 2010). Therefore, the plantation industry is selected as the focus of this study with regards to its potential growth in Malaysia in the future. This study aims to examine the relationship among independent board composition, CEO

duality and firm performance. The findings of this study are expected to provide an in-depth knowledge of corporate governance in the plantation industry by filling in the gap in the literature on corporate governance and it is also expected to benefit organisational stakeholders such as managers, investors, the government and customers in terms of theoretical and managerial significance.

The data was collected using secondary data including each company's annual report and its official website as well as DataStream. Such data was obtained manually by calculating the number of directors on the board (Board Size) in order to determine the number of independent non-executive/outside director on the board (Ibrahim & Samad, 2011) and also the dual position of chairman and CEO in the years from 2007 to 2010, making up a total of 41 listed plantation companies. Firms that were newly listed after 31 December 2007 or that were delisted from the Main Board were excluded. This study also excluded firms which failed to comply with any obligations under Practice Notes No 4 (PN4) and No 17 (PN 17). PN4 was also amended to PN 17 effective as of January, 2005 (Ibrahim & Samad, 2011). At the same time, the firm's accounting period must have fully completed 12 months' of operation for the business year and should be in line with the same end of year over a four-year period (Ibrahim & Samad, 2011). This study also included firms that changed the name of the company during the study period. In total, there were 40 firms meeting the criteria with only one PN17 firm having to be dropped.

Methodology

This study utilised the multiple regression technique to determine the relationship among board composition, CEO duality and firm performance as follows.

$$Y_{it} = \beta_0 + \beta_1 X1_{it} + \beta_2 X2_{it} + \beta_3 X3_{it} + \beta_4 X4_{it} + \beta_{35} X5_{it} + \beta_6 X6_{it} + \beta_7 X7_{it} + \beta_8 X8_{it} + e_{it}$$

Where

Y_{it} = Return on Asset (ROA) or Return on Equity (ROE) or Tobin's Q

β_0 = Constant

βj = Coefficient of the explanatory variable, with j =1,2….8

$X1_{it}$ = CEO Duality (CD)

$X2_{it}$ = Board Composition (BC)

$X3_{it}$ = Board Size (BSize)

$X4_{it}$ = Firm Size (FSize)

$X5_{it}$ = Firm Age (FAge)

$X6_{it}$ = Firm Growth (Growth)

$X7_{it}$ = Total Debt to Total Assets (Debt 1)

$X8_{it}$ = Total Debt to Total Equity (Debt 2)

e_{it} = Error term

It is important to state that this study adopts two accounting performance measures (ROA and ROA) and a market performance measure (Tobin's Q) to measure the performance of the firm. A summary of the terms of variables is presented in Table 1.

TABLE 1
Summary of Terms of Variables

Variables	Acronym	Terms of Measurement
Dependent		
Return on Assets	ROA	Profit before interest and tax payment Total assets Kyereboad-Coleman and Biekpe (2006); Haniffa and Hudaib (2006)
Return on Equity	ROE	Total Profit after Interest and Tax Payment Total Equity *Kyereboad-Coleman and Biekpe (2006); Kajola (2008)*
Tobin's Q ratio	Q-Ratio	Market Value of Equity Capital + Book Value of Debt Book Value of Total Assets *Haniffa and Hudaib (2006); Ehikioya (2009),* Note: Book values of total assets should not differ markedly from replacement cost due to reasonably frequent updating of book values to reflect market values (Black *et al.,* 2006)
Independent		
CEO duality	CD	Dummy variable: (1) CEO combined as the chairman (0) Otherwise Abdullah (2004); Johari *et al*. (2008); Kajola (2008); Ehikioya (2009)
Board Composition (%)	BC	Number of outside directors Total number of directors (Board Size) Haniffa and Hudaib (2006); Kajola (2008)
Control		
Board Size	BSIZE	Natural Logarithms of Total Board Members Jackling and Johl (2009); Arosa et al. (2010)
Firm Size	FSIZE	Natural Logarithms of Total Assets Arosa *et al.* (2010)
Firm Age	FAGE	Natural Logarithms of the number of years firm was incorporated Wang (2006);Barontini and Caprio (2006); Arosa *et al.* (2010)
Growth (%)	GROWTH	Current Year's Revenue-Last Year's Revenue Last Year's Revenue Wang (2006); Barontini and Caprio (2006); Arosa *et al*. (2010)
Debt 1	DEBT 1	Total Liability Total Assets Masheyekhi and Bazaz (2008); Rashid *et al.* (2010)
Debt 2	DEBT 2	Total Liability Total Equity Wang and Oliver (2009); Rashid *et al.* (2010)

Descriptive Analysis

The statistics in Table 2 indicate that the majority of listed plantation firms (90 %) are engaged in the oil palm business in Malaysia due to the increasing demand for edible oils and animal proteins under oil crop cultivation, particularly oil palm, in the last few decades. Today, palm oil is the most widely traded edible oil. Its production has increased almost twice since the 1990s.

As shown in Table 3, the majority of listed firms (80 %) have 6 to 9 board

TABLE 2
Core Business of Sampled Firms

Business Activity	Percentage (%)	Number of Company
Oil Palm	90.0	36
Oil Palm and Rubber	5.0	2
Oil Palm and Cocoa	2.5	1
Oil Palm, Coconut and Banana	2.5	1
Total	100.0	40

TABLE 3
Number of Directors on the Board and Number of Independent Directors

No. of Persons	No. of Directors on Board		No. of Independent Directors	
	Percentage (%)	Number of Company	Percentage (%)	Number of Company
2-5 persons	7.5	3	90	36
6-9 persons	80.0	32	10	4
10-13 persons	12.5	5	0	0
Total	100.0	40	100.0	40

members. The Code of Malaysia corporate governance does not limit the number of directors on a board but Abduallah (2004) argues that broad size should be 8 to 9 persons for the board to be effective. Table 4 presents 90 % of the listed firms that have 2 to 5independent directors. The MCCG requires at least two or one third of the company's board members to be independent directors. Hence, listed plantation firms mostly comply with the MCCG.

Table 4 presents the descriptive analysis of the 40 companies in the sample. For the dependent variables, the mean of ROA, ROE and Q-ratio is about 9.8 %, 9.4 % and 0.857. The Q value is near to 1, implying that on average, the firms are perceived to be valuable for shareholders (Khatab *et al.,* 2011). The majority of the firms comply with the provisions of the MCCG and the listing of Bursa Malaysia as the mean of board composition is about 5 %, which requires that more than two or one third of the members should be independent non-executive directors on the board. Almost 20.6 % of the sampled firms have one person holding the dual position of CEO and Chairman while 79.4 % of the firms have different individuals holding the posts of CEO and Chairman. Hence, it can be argued that the MCCG (revised 2007) recommendation for the separation of the CEO and Chairman posts has been complied with by the majority of the listed firms in the plantation sector. However, this percentage is lower compared with the study of Abidin *et al.* (2009) which finds that 29.3 % of the selected sample practices CEO duality.

The mean of the board size is about 8 directors, ranging from minimum 4 directors to maximum 13 directors. This result fulfils the board size requirement that there should be 8 or 9 persons on the board in order for

TABLE 4
Descriptive Statistics for Independent, Dependent and Control Variables

Variables	Minimum	Maximum	Mean	Median	Mode	Standard Deviation
ROA	-0.165	1.262	0.098	0.068	-0.165	0.133
ROE	-0.168	0.471	0.094	0.078	-0.168	0.986
Q-Ratio	0.194	3.557	0.856	0.714	0.194	0.694
BC	0.167	0.857	0.497	0.444	0.333	0.168
CD	0.000	1.000	0.206	0.000	0.000	0.406
BSIZE (log)	0.600	1.110	0.863	0.845	0.780	0.105
FSIZE (log)	5.448	10.074	8.007	8.470	5.448	1.280
FAGE (log)	0.301	1.973	8.467	1.362	1.342	0.331
GROWTH	-1.0	8.980	0.318	0.077	0.000	1.808
DEBT 1	0.001	1.00	0.219	0.147	0.001	0.206
DEBT 2	0.001	3.235	0.793	0.497	0.001	0.794

it to be effective (Abdullah, 2004). The mean of firm size is around RM88,900,000 ranging from minimum RM280,825 to maximum RM11,859,088,000. The average operating years of the firms is 28.82 years. Firm growth ranges from100 % to 898 % with a mean of 31.8 %, implying that some of the firms are growing faster while others tend to be at default. The average of total debt to total assets (debt 1) is 21.9 %, which indicates that merely 20 % of the assets are financed by debt whereas the mean of total debt to total equity (debt 2) is 79.3 %. Firm growth ranges from100 % to 898 % with a mean of 31.8 %, implying that some of the firms are growing at a faster speed while others tend to be at default.

The results shown in Table 6 indicates that the Tolerance and VIF values are well below the cut-off points for determining the presence of multi-collinearity, thus suggesting no multi-collinearity problems with cross correlation.

TABLE 5
Collinearity Statistics

Variables	Tolerance	VIF
(Constant)		
BC	0.823	1.215
CD	0.790	1.266
BSIZE(log)	0.592	1.690
FSIZE (log)	0.789	1.268
FAGE	0.678	1.476
GROWTH	0.832	1.202
DEBT 1	0.675	1.120
DEBT 2	0.781	1.365

Regression Analysis

Table 6 presents the result of regression analysis by performing the Ordinary Least Square (OLS) regression in this study. The R-squares for ROA, ROE and Tobin's Q are 10 %, 15.97 and 20.4 % respectively. Of these three models, none of the board composition and CEO duality show a significant relationship with ROA and ROA respectively. The overall significance level of Tobin's Q model is higher and the board composition and dual CEO are significant.

TABLE 6
Factors Affecting Firm Performance in the Plantation Industry, 2007-2010

Variables	ROA			ROE			Tobin's Q ratio		
	Coefficient	t-value	Sig.	Coefficient	t-value	Sig.	Coefficient	t-value	Sig.
BC	-0.040	-0.059	0.555	-0.027	-0.561	0.575	-0.670	-2.014	0.046
CD	-0.028	-1.079	0.282	-0.024	-1.262	0.209	0.395	3.063	0.003
BSIZE (log)	0.154	1.488	0.139	0.132	1.782	0.077	-0.653	-1.287	0.200
FSIZE (log)	-0.004	-0.541	0.589	-0.002	-0.416	0.678	-0.021	-0.520	0.604
FAGE (log)	0.031	0.991	0.324	0.027	1.211	0.228	-0.067	-.0431	0.667
GROWTH	0.026	2.755	0.007	0.029	4.307	0.000	0.040	-0.843	0.401
DEBT 1	-0.107	-1.273	0.205	-0.118	-1.976	0.050	2.092	5.099	0.000
DEBT 2	0.000	-0.043	0.966	0.030	1.925	0.056	-0.503	-4.722	0.000
	$R^2 = 0.100$			$R^2 = 0.159$			$R^2 = 0.204$		
	Adjusted $R^2 = 0.052$			Adjusted $R^2 = 0.115$			Adjusted $R^2 = 0.162$		
	F value = 2.088			F value = 3.575			F value = 4.848		
	F significance = 0.040			F significance = 0.001			F significance = 0.000		

Independent board composition is statistically negatively correlated with Tobin's Q with a t-value of -0.670. This suggests that independent directors do not necessarily have a positive association with firm performance if they do not play their role properly. If the board is dominated by a large number of independent directors, poor investment decisions may result such as investing in undervalued projects. CEO duality is positively significant with Tobin's Q, consistent with Yermarck (1996) but not Haniffa and Hudaib (2006) and Ehikioya (2009). A firm can perform well under dual leadership as CEO duality would lead to better knowledge and understanding of the firm's operation and environment, allowing the firm to make a better investment decision. He or she is not only responsible for the running of the firm's operation but also the running of the board.

CONCLUSION

This study aims to examine the relationship between governance mechanisms (i.e. independent board and CEO duality) and firm performance in the plantation sector in the period from 2007 to 2010 by using both accounting and market-based performance measures. The majority of the listed firms have 6 to 9 directors. Abdullah (2004) states that board size should be 8 or 9 persons in order for the board to achieve effectiveness. In addition, an independent board has a negative relationship with firm performance. Raheja (2005) argues that outside directors are not involved in day-to-day management while inside directors have a greater knowledge of the firm. According to Abdullah (2004), independent directors might not be truly independent while they may have connections in unlisted subsidiaries. The results also recommend that listed firms should balance their number

of independent directors on the board of directors. On the other hand, CEO duality has a positive relationship with firm performance as suggested by the stewardship theory. It can be interpreted that a firm can perform well under a dual leadership structure even though the MCCG recommends that the dual position should be avoided The CEO and chairman positions should be combined rather than separated as such a merging can strengthen the leadership of a company (Ramdani and Witteloostuijn, 2009). Baliga *et al.* (1996) suggests that a non-dual leadership structure would limit innovation, and Davis *et al.* (1997) believe that a dual leadership structure can help listed companies to achieve leadership that is unambiguous and strong in order to achieve internal efficiency through unity of command; to remove potential for conflict between the chairman and CEO; and also to avoid confusion as a result ofhaving two different public spokespersons.

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APPENDIX

Pearson Correlation Analysis

Variable	ROA	ROE	Q-Ratio	BC	CD	BSIZE (log)	FSIZE (log)	FAGE	GROWTH	DEBT 1	DEBT 2
ROA	1	0.716**	-0.052	-0.083	-0.074	0.128	-0.039	0.450	0.200*	-0.151	-0.124
ROE		1	-0.217**	-0.100	-0.082	0.136	-0.058	0.068	0.302**	-0.037	0.054
Q-Ratio			1	-0.115	0.153	-0.059	0.014	-0.010	-0.036	0.170*	-0.067
BC				1	0.186*	-0.295**	0.098	-0.010	0.004	-0.137	-0.105
CD					1	0.002	-0.006	0.145	-0.023	-0.087	-0.015
BSIZE (log)						1	0.014	0.002	-0.067	-0.042	-0.026
FSIZE (log)							1	0.065	0.004	-0.003	-0.132
FAGE								1	-0.047	0.047	0.074
GROWTH									1	0.021	-0.018
DEBT 1										1	0.788**
DEBT 2											1

**Correlation is significant at the 0.01 level (two-tailed)

*Correlation is significant at the 0.05 level (two- tailed)