School of Accounting

Faculty of Business

Impact of Corporate Governance on the Financial Performance of Financial Institutions in Malaysia

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Declaration

To the best of my knowledge and belief this thesis contains no material previously published by any other person except where due acknowledgment has been made. This thesis contains no material which has been accepted for the award of any other degree or diploma in any university.

Signature:

Date: 24.06.2017

Dedicated to my parents

Mr.K.Viswanathan

&

Mrs.K.Kamalam

Without their blessing it was impossible for me to complete this study

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List of Abbreviations

SN	Abbreviation	Definition
1	AFA	Asean Federation of Accountants
2	AC	Audit Committee
3	BIS	Bank for International Settlements
4	BNM	Bank Negara Malaysia
5	BC	Board Composition
6	BS	Board Size
7	CMP	Capital Market Plan
8	CEO	Chief Executive Officer
9	CG	Corporate Governance
10	DEA	Data Envelopment Analysis
11	EBIT	Earnings Before Interest and Taxes
12	FCCG	Finance Committee on Corporate Governance
13	FIA	Financial Institutions Age
14	FIS	Financial Institutions Size
15	FRF	Financial Reporting Foundation
16	FAST	Fully Automated System for Issuing/Tendering
17	GAAP	Generally Accepted Accounting Principles

18	GCGLI	Guidelines on Corporate Governance for Licensed Institutions
19	IBA	Islamic Banking Act
20	ICGN	International Corporate Governance Network
21	IFAC	International Federation of Accountants
22	IFC	International Finance Corporation
23	KLSE	Kuala Lumpur Stock Exchange
24	MASB	Malaysian Accounting Standard Board
25	MCCG	Malaysian Code on Corporate Governance
26	MIAs	Malaysian Institute of Accountants
27	MICG	Malaysian Institute of Corporate Governance
28	MOF	Ministry of Finance
29	MSWG	Minority Shareholders Watchdog Group
30	OECD	Organization for Economic Cooperation and Development
31	QQ Plot	Quantile-Qualtile Plot
32	PAT-PD	Profit After Tax excluding Preference Dividend
33	ROA	Return on Asset
34	ROE	Return on Equity
35	RONW	Return on Net worth

36	SOX	Sarbanes–Oxley Act
37	SEC	Securities and Exchange Commission
38	SCA	Securities Commission Act
39	SIA	Securities Industries Act
40	SPSS	Statistical Package for the Social Sciences
41	VIF	Variance Inflation Factor

ABSTRACT

A strong and effective regulatory framework of corporate governance is essential to ensure efficiency and better financial performance of financial institutions. This study aims to investigate the impact of corporate governance on the financial performance of licensed financial institutions in Malaysia, based on agency theory. Agency theory explains the relationship between principal and the agent in the business environment. It has been argued that audit committee, board composition and board size are effective corporate governance mechanisms to minimize agency problems between investors and management. The objectives of the study are to determine the impact of corporate governance on the return on assets (ROA), and on return on equity (ROE) of licensed financial institutions in Malaysia; and to identify whether these financial institutions comply with the Bank Negara Malaysia's (BNM) guidelines as provided in 'Guidelines on Corporate Governance for Licensed Institutions 2013' (GCGLI 2013).

The GCGLI 2013 set out broad principles, minimum standards and specific requirements for effective corporate governance, which are expected of licensed institutions. This study uses Agency theory, which focus on the separation of ownership and control as a theoretical framework, to examine the corporate governance practices of financial institutions in Malaysia. The study applies cross sectional data to predict the values of dependent variables (financial performance) through the independent variable (corporate governance) using data of financial institutions listed in BNM, Malaysia. This study analyses 83 licensed financial institutions functioning in Malaysia, it was conducted for the period of 2014 and the data was collected from annual reports of financial institutions issued by Bursa Malaysia. Diverse range of analyses ranging from descriptive statistics to multiple regression model are used in this work. The study developed four models of multiple regression analyses; two each for ROA and ROE.

The findings of the study show that the audit committee has a significant impact on ROA and ROE. The result underlines the importance of independent directors in audit committee who not only brings new ideas but are also competent in monitoring

managers. This will add value to the financial reporting of the company, and will attract more investors and thereby improve financial performance. Although board composition has non-significant impact on return on asset and return on equity, it is expected that it will have an impact in the long run. Board size also has a positive significant result with ROA and ROE. This shows that the members of the board are highly effective in monitoring management and decision making and also have diverse set of skills and ideas. The study also explored the percentage of compliance of GCGLI 2013 by financial institutions and found that majority of financial institutions complied with BNM's guidelines regarding audit committee, board composition and board size.

The results of the study provide a representation of financial performance of these financial institutions thereby assisting the prospective investors to make investment decisions. The findings of the research can serve as a direction to the authorities to develop effective corporate governance framework and to set up standardized framework for financial institutions in Malaysia. Further, the result would encourage the financial institutions to have more number of independent directors in audit committee and also to maintain the large size boards. Based on the analyses and findings, a future study may be attempted to include Tobin Q as a performance measure and to look at the long-term impact of corporate governance.

KEYWORDS: corporate governance, financial performance, Agency theory, Guidelines on corporate governance for licensed institutions.

CHAPTER 1

INTRODUCTION

1.1 INTRODUCTION

In the past, the term corporate governance (CG) was little known to all, but nowadays it is frequently used by researchers, academicians, investors, regulators and general public. Studies related to corporate governance has gained importance after many financial crises and business scandals. In recent years, the policy makers and regulators have rendered a lot of attention to corporate governance. This study attempts to investigate the impact of corporate governance on the financial performance of licensed financial institutions in Malaysia.

This chapter lays out the overall frame work of the study. It presents the objectives of the study, and introduces the various aspects and issues of corporate governance in general and specifically in Malaysia. The various sections of this chapter include the background of the study, statement of research problem leading to main objectives of the study thereby presenting two important research questions that this study has tried to answer. Subsequently, the significance of the study is discussed. This chapter also lays out the chapter arrangements of the study.

1.2 BACKGROUND OF THE STUDY

A strong and effective regulatory framework of corporate governance is essential to ensure efficiency and better financial performance of financial institutions. Corporate Governance has attracted a lot of attention in the developed countries as well as in developing countries after giant firms such as Enron and World Com fell in a row. The importance of corporate governance has become familiar due to various reasons; one of the most important reasons are the corporate scandals around the globe such as the Pewaja Steel Sdn. Bhd. scandal in Malaysia in 1995 (Norlia et al. 2011), WorldCom, a second largest long distance American phone company scandal revealed in the year 2000, Enron, an American energy company scandal revealed in October,

2001 (Joel & Dondjio, 2012), the Satyam computers services scandal in 2009 in India (Madan 2013). All these scandals around the world taught a lesson in framing effective, strong and regulated framework for corporate governance.

Financial crisis is also one of the reasons for recoganising the importance of corporate governance. Many key businesses failed due to the crisis. The Barings Bank, a British merchant bank collapsed in 1995. Number of companies in private and public sectors of East Asian economies collapsed in countries like Thailand, Indonesia, Philippines and Malaysia in second half of 1997. Asian financial crisis of 1997 and global financial crisis of 2008 threatened the collapse of some financial institutions and created awareness among governments, regulators, investors and financial institutions to the importance and requirement of strong corporate governance (Dallas, 2012). Akpan (2007) cited several cases of collapses of banks due to improper regulated framework in the name of corporate governance like Alpha Merchant Bank Limited Nigeria, Societe general bank Limited Nigeria and The Continental Bank of Kenya Limited. It also exposed serious flaws in corporate governance of some highly respectable companies namely Adephia Communications Company, Tyco International Limited, Parmalat in Italy and Global Crossing Limited and US investment bank Lehman Brothers which collapsed in 2008; all these instances highlighted the importance of regulated framework of corporate governance. It is expected that such strong regulatory and supervisory frame work of corporate governance will avoid future financial crisis and corporate scandals.

Banks play a very important role in the economic development of every nation. Akpan and Riman (2012) contend that the failure of the banking system results in 15% fall in gross domestic product of developing countries. In Malaysia, government and industries are playing a pivotal role in efforts to regain investors' confidence in capital market after the financial crisis. Financial institutions in Malaysia fascinate the investors through formulating strong corporate governance. Banks play a crucial role in accepting deposits, lending loans to individuals, businesses and government to provide economic contribution.

Banks can increase efficiency through ensuring shareholders and stakeholders' confidence, by complying with various policies and recommendations of corporate governance (Soludo, 2004). Some studies (Balasubramanian, Black & Khanna, 2010; Samontatary, 2010) have documented that economic progress and expansion of a state are closely related to good corporate governance. A well-developed corporate governance system is the key to economic growth through financial development (Samiksha & Nangia, 2014).

Morck et al. (1989) has named good corporate governance, which includes effective marketing discipline, strong prudential regulation and supervision, accurate and reliable accounting financial reporting systems, a sound disclosure regimes and an appropriate savings deposit protection system to be the keys to the economic durability of a nation. Corporate governance practices are handy for investors and creditors to make investment decisions. Sound corporate governance is a result of well-functioning supervision in banks (Heidi & Marleen, 2003). Effective control of management results in market leadership, increasing company growth and investors' confidence (Meier, 2000). Due to globalization and technological development, financial arena becomes more open to new products and services. In order to face the international standards, there is a need for countries to have sound corporate governance which will strengthen and upgrade the institution to survive in an increasingly open environment (Kashif, 2008).

In early 1990s there were large number of studies on corporate governance in US, UK, Japan and Germany. However, the recent years have seen a surge in the number of researches on corporate governance around the world. The reasons for the development of these researches are due to integration of global economy and corporate scandals. Most of the studies across the world are related to corporate governance practices in non-financial institutions. Only few studies are related to financial institutions' practice on corporate governance especially banking sector (Liang et al., 2013; Abei et al. 2012 ; Andres and Vallelado, 2008; Caprio et al., 2007; Adams and Mehran, 2005; Levine, 2004; Macey and O'Hara, 2003).

According to the Financial crisis inquiry report (2011) the dramatic failure of corporate governance is the key cause for the crises. Some organizations like Technology resources industries Bhd., Transmile, Megan media and Malaysia Airlines System (MAS) also faced the governance failure (Abdullah, 2007). The most prominent example of corporate governance failure in Malaysia was the collapse of Perjawa steel Sdn. Bhd. in 1995 due to lack of internal control system (Jeyasingam, 2004). It is expected that by having a good corporate governance mechanism, the management may make decisions in the best interest of the financial institutions with efficiency resulting in better financial performance.

Strong enforcement by the Bank Negara Malaysia (BNM) on good corporate governance indicates that the BNM is concerned with the way the financial institutions are being managed. Malaysia's legal system also plays an important role in corporate governance. Motivation for this study to examine the corporate governance (CG) and financial performance of licensed financial institutions is made possible by their dominant market share that is essential in facilitating the economic growth; the financial institutions must also improve their efficiency in order to ensure the survival of the business.

The audit committee is a committee of the board of directors which is responsible to go through the financial reporting process, selection of independent auditor, receipt of internal and external audit results. Further, the committee assists the board of directors to fulfill its corporate governance. The audit committee includes independent non-executive directors. The independent non-executive directors have an important role in fulfilling this responsibility irrespective of how formal audit committee of the board has been constituted (The Director's Handbook, 2010). The question is whether number of independent non-executive members in the audit committee has any impact on the financial performances of licensed financial institutions.

Board composition normally speaks about the issues related to board independence. Number of board of directors is a mechanism to solve principal (shareholder) agent

(managers) relationship. Sometimes the number of directors is not a solution to solve conflict of interest between the principal and the agent, as the directors themselves are agents and their interests are not aligned with shareholders' interests, so this issue is resolved through appointment of outside directors. Outside directors also sometimes are known as independent directors, who do not have material relationship with the company and do not own shares in the company. Fama and Jensen (1983) argued that appointment of more independent directors is likely to improve the firm performance. In another study Hermalin and Weisbach (1988) report that inside directors are more important than outside directors. The inside director mobilizes the information and conveys to the management than outside directors. Therefore, it is an open question whether the independent non-executive directors in the board has an impact on financial performance of licensed financial institutions.

Board size denotes number of directors in the board. It is crucial for all financial institutions to implement effective governance to maintain its goodwill among stakeholders and sustain financial progress. From the various corporate governance mechanisms, board occupies a predominant role and board of directors is the hub of corporate governance. One of the major issues in agency theory is the trade-off between top management and shareholders. Monitoring board of directors is one of the mechanisms for solving this tradeoff. Board of directors has fiduciary obligation to shareholders as well as depositors. Therefore, the board acts as monitor and advisor to the top management. Existing literatures support and provide information about board size in solving agency issues. Studies have argued in both ways about the number of directors on the board; that a large board faces difficulties of coordination, communication and flexibility in decision making, further, the small board can take quick decisions. Previous academic research, does not provide any solid evidence on size of board and its impact on financial performance of licensed financial institutions.

Prudential financial policy department of Bank Negara Malaysia issued Guidelines on corporate governance for licensed institutions (GCGLI 2013). The guidelines came into effect on 19 June 2013. The guidelines consist of 14 principles and each principle has its own paragraphs (sub sections). The guidelines are applicable to licensed

institutions, holding companies and any other institution specified by BNM. The principles provide various norms such as the specified information about the selected norms of audit committee, board composition and board size. However, few studies on corporate governance with performance are related to banking institutions. There are many studies about corporate governance and performance of non-financial institutions. There is not yet a systematic study as a whole for the licensed financial institutions in Malaysia with performance and compliances.

Therefore, the present study is focused on the impact of corporate governance (audit committee, board composition and board size) on the financial performance of licensed financial institutions in Malaysia. It also explores the licensed financial institutions in Malaysia and its compliance with BNM's revised guidelines on corporate governance for licensed institutions (GCGLI 2013) as selected norms.

1.3 STATEMENT OF THE PROBLEM

The business community in the developed countries has been aware of corporate governance's impact on the performance of an institution for decades (Ingrid & Josie 2005). The practice of corporate governance has already been established in Western developed countries, such as USA and UK (Chambers, Chapple, Moon, & Sullivan, 2003).

Until 1980, the researches related to corporate governance were focused only on US companies. During the early 1990 there are limited number of studies on financial institution related corporate governance and its performance in Malaysia. A study by Sheila (2012) analyzed corporate governance and strategic information disclosure in Malaysian listed banks for 5 years before and after Malaysian Code on Corporate Governance (MCCG 2001). Some previous studies in Malaysia focused on non-financial institutions like Abdifatah, 2014; Ghazali N.A. 2010; Ranjbar.A 2008 and some researches in Malaysian context (Nur and Siti (2014); Peong et al. (2012) concentrate on some banking institutions, but these studies are not focused on whole financial institutions which includes banking institutions, insurance companies and takaful operators. Since, there has been a remarkable lack of academic studies

empirically analyzing impact of corporate governance and financial performance on whole financial institutions in Malaysia, most academic papers on corporate governance focus on non-financial firms and exclude financial firms from their data (De Hann, Jakob & Razvan, 2013).

The Bank Negara Malaysia (BNM) is the Malaysian Central Bank and it was established on 26th January 1959. One of the functions of BNM is to regulate the country's financial institutions. The financial institutions licensed under BNM are called as licensed financial institutions. These institutions are mainly classified into three; namely, licensed banking institutions, licensed insurance companies and takaful operators. BNM insists on the implementation of corporate governance for licensed institutions. For the regulation of financial institutions, BNM issues guidelines which are called Guidelines on Corporate Governance for Licensed Institutions (GCGLI 2013). All the financial institutions are advised to comply with GCGLI 2013. This study also investigates whether the licensed financial institutions comply with the corporate governance guidelines set up by Bank Negara Malaysia.

According to the literature, corporate governance related studies in Malaysia are either connected to non-financial institutions or banking institutions separately. The research focused on corporate governance and performance of all the financial can be identifies as research gap in this area. Therefore, it is interesting to understand whether corporate governance has an impact on financial performance of financial institutions in Malaysia. This study aims to fill the research gap by providing findings about the significance of audit committee, board composition and board size in financial performance of financial institutions in Malaysia. Effective corporate governance (CG) may reduce agency problems by ensuring the accountability of respective individuals in the organization. An effective CG can reduce agency problem and agency cost (Shleifer & Vishny, 1997). Mallin (2010) states that agency theory has brought about a significant improvement in the framework of corporate governance. It is expected that having effective CG mechanism leads management to make decisions in the best interest of the investors and ensures better financial performance of the financial industries. In short, it thus raises two research questions to achieve the study objectives and they are briefly presented in the following section.

1.4 RESEARCH QUESTIONS

The licensed financial institutions adopt sound corporate governance standards and practices, they ensure that these institutions are managed safely and soundly. Strong corporate governance provides safeguard against all kinds of mismanagement and fraudulent activities. In addition to the application of effective corporate governance practices, it also enhances corporate accountability, market discipline and transparency. Corporate governance impact on financial institutions' financial performance has been very vital and important issue for the last decade due to financial distress all over the world.

BNM issues corporate governance related guidelines called "Guidelines on Corporate Governance for Licensed Institutions" (GCGLI 2013). It introduces 14 principles of corporate governance for licensed institutions. The BNM's broad principles, standards and requirements are aligned with the principles enshrined in (a) Malaysian Code of Corporate Governance (MCCG), (b) The Bank for International Settlements (BIS) Guidelines on "Enhancing Corporate Governance for Banking Organizations" and (c) Other international best practices on corporate governance.

The main idea of this study is to determine the impact of GCGLI 2013 on the financial performance of licensed financial institutions in Malaysia. Therefore, this study is guided by the following research question:

1. What are the impacts of corporate governance on the financial performance of licensed financial institutions in Malaysia?

The BNM formulated the guidelines based on the fundamental concepts of responsibility, accountability and transparency with greater emphasis on the role of the board and management. These guidelines are applicable to (i) licensed institutions; (ii) holding companies and (iii) any other institution specified by Bank Negara Malaysia. Various research studies indicate that any organization failing to comply with the corporate governance may lead to corporate scandals or corporate failure. Further, the investors' faith on the organization will be based on the organizations' sincere adoption of norms. Therefore, it is necessary to identify whether the financial

institutions comply with the corporate governance or not. It poses the following research question.

2. Do the licensed financial institutions in Malaysia comply with the Bank Negara Malaysia's Guidelines i.e. "Guidelines on Corporate Governance for Licensed Institutions" (GCGLI 2013)?

1.5 OBJECTIVES OF THE STUDY

The overall objective of the study is to identify the impact of corporate governance on the financial performance of licensed financial institutions in Malaysia and to investigate the licensed financial institutions compliance with BNMs corporate governance guidelines. The main objectives of the study are:

Objectives 1: To determine the impact of corporate governance on return on assets of licensed financial institutions in Malaysia.

1.1 To determine the impact of Audit committee on Return on assets
1.2 To determine the impact of Board composition on Return on assets
1.3 To determine the impact of Board size on Return on assets

Objectives 2: To determine the impact of corporate governance on return on equity of licensed financial institutions in Malaysia.

2.1 To determine the impact of Audit committee on Return on equity
2.2 To determine the impact of Board composition on Return on equity
2.3 To determine the impact of Board size on Return on equity

Along with the main objectives this study also has a sub objective as shown below:
Sub Objective: To identify whether the financial institutions in Malaysia comply with the Bank Negara Malaysia's Guidelines i.e. "Guidelines on Corporate Governance for Licensed Institutions 2013" (GCGLI 2013).

1.6 SIGNIFICANCE OF THE STUDY

This research is significant to different groups of people involved in corporate governance and financial institutions. The significance of study is classified into five aspects such as: (i) provide knowledge to shareholders, (ii) Provide valuable information to governing councils, (iii) aid to investment decisions (iv) fill the research gap and provide base for further research and (v) licensed institutions working on safety and sound.

1.6.1 Provide Knowledge to stakeholders

Among all industries, the corporate governance guidelines are most important for financial institutions because they play an important role in the economic development of a country (Matama, 2008). According to Bank for International Settlement 2009, all banks should have a proper corporate governance mechanism for maintaining public trust and for the proper functioning of the banking sector. Depositors, investors, directors, and stakeholders have an interest in the financial performance of banks (Adam & Mehran, 2003). Currently, corporate governance has received lot of attention due to a number of high profile corporate failures like WorldCom and Enron (Duff, 2009). Effective corporate governance would enhance management practices and provide reliable information to the stakeholders. The study deeply analyses corporate governance guidelines issued by BNM viz. GCGLI 2013 and provide information about impact of guidelines on financial performance. This will help the stakeholders of financial institutions can acquire knowledge about corporate governance and financial performance of their associated institutions. The results of this study may of use for stakeholders to check if accepted standards of business are adopted by the financial institutions.

1.6.2 Provide valuable information to governing councils

In the last five decades, corporate governance issues have become important in academic literature and also in public debates; before that the word corporate governance did not exist in English language (Zingales, 1997). Financial institutions are also in need of effective corporate governance to eradicate the risk of loss and to

improve investors' confidence. Banks provide a wide range of services to many sectors of the economy and to the quality of life of many individuals. Different insurance policies such as life insurance or mortgage contract insurance can be bought from insurance firms. Insurance firms and banks not only serve individuals, but also insure other business firms. Therefore, a bank can swallow another bank's losses if it defaults on its debts. However, it could carry a systemic risk for the economy, as a fall of a major financial institution could adversely affect other banks. So, the effective corporate governance in these banking and insurance sectors is highly important. This research, therefore, provides valuable information to governing councils of banking and insurance companies in Malaysia.

The investors and depositors can acknowledge good business practices, and these business practices are implemented through corporate governance. In fact, the subject of corporate governance is practically very important. Guidelines in this regard have been prepared by various international bodies, such as the International Corporate Governance Network (ICGN) and the Organization for Economic Cooperation and Development (OECD). The OECD guidelines were called "Principles of Corporate Governance", which were first published in 1998 and revised in 2004. In present era, it has become increasingly hard to determine the real causes that could influence practice (Kuratko & Morris, 2003). It is thought that, in order to minimize distrust in the business world, good governance could be the best option.

Good corporate governance may reduce the principal agent problem by ensuring accountability of the respective individual in the banks. It is expected that by having good corporate governance mechanism, management may make decisions in the best interest of the shareholders, and could lead to better performance of banks. In addition, strong enforcement by the BNM on corporate governance mechanism indicates that the BNM is concerned about management of banks. This research provides useful information on how the governance of financial institutions in Malaysia can be improved. The findings of this research would encourage the authorities to develop effective corporate governance framework and to set up standardized framework for Malaysia.

1.6.3 Aid to investment decisions

This empirical study contributes to the relationship between corporate governance and financial performance in licensed financial institutions after implementing CGCLI 2013. The findings of this study would help investors as they can appraise the performance of banks and insurance companies, adjust policies, make plans and decisions in appropriate time (Pasiouras & Kosmidou, 2007). In the present scenario, the investors are well aware of the role of financial institutions and its mechanism of complying corporate governance to make effective investment decisions.

1.6.4 Fill the research gap and base for further research

In Malaysia some studies (Abdifatah, 2014; Ghazali N.A. 2010) regarding the relationship between corporate governance and firm performance focused on non-financial institutions. Studies by Peong et al. (2012); Nur and Siti (2014) focused on some categories of banks performance with its corporate governance mechanism. In a study of Malaysian listed companies Ranjbar. A. (2008) analysed the impact of CG with financial performance and found a positive relationship between them. In Malaysia, Ramli, J.A. & Ramli, M.I (2016) analysed CG and corporate performance in an Islamic perspective and results showed insignificant influence on all six proxies of CG with profit maximization. Based on the literature review, only few studies are found in the context of listed financial institutions in Malaysia Earlier studies seems to disregard financial institutions after GCGLI 2013, present study aims to fill the existing gap found in corporate governance literature. Very few empirical studies have been carried out specifically on developing economies like Malaysia. This scarcity of research justifies the importance of this study, which intends to provide guidance to corporate governance of all listed financial institutions in Malaysia.

This research aims to narrow down the gap by providing empirical evidence after the implementation of GCGLI 2013, and contribute to the body of knowledge relating to corporate governance on licensed financial institutions. In this regard, the study helps to fill the lacuna in the corporate governance and financial performance literature by the focusing on the context of Malaysian financial institutions. Thus, the findings of

this study aims to provide valuable knowledge to stakeholders, regarding the corporate governance practices by the financial institutions in Malaysia which will improve the trust of stakeholders, and contributes to the growth of business in long term. The results of the study will also serve as a database for further researches in this field.

1.7 CHAPTER SCHEME

The present study titled 'The Impact of corporate governance on the financial performance of financial institutions in Malaysia' is organized into 6 chapters which are Introduction, Corporate governance and financial institutions in Malaysia – A Glance, Theoretical framework and hypothesis development, Research methodology, Results and Discussion and Conclusions, limitations and recommendations.

Chapter: 1 Introduction

This chapter comprises information related to background of the study, statement of the problem, research questions, objectives of the study and significance of the study. In addition, it includes chapter scheme of the thesis.

Chapter: 2 Corporate governance for financial institutions in Malaysia – A Glance

This chapter incorporates connotation of corporate governance, historical overview of corporate governance, development of corporate governance in Malaysia, institutional contribution in Malaysian corporate governance, financial systems in Malaysia and corporate governance for financial institutions in Malaysia.

Chapter: 3 Literature review and hypothesis development

This chapter composes introduction to agency theory, corporate governance, hypothesis development, details about independent variables, dependent variables, control variables and research framework.

Chapter: 4 Research methodology

This chapter contains research method, study population, sample size and method, types and sources of data collection, period of study, geographical coverage, variables and measurement of variables, research framework and data analysis and also research hypothesis.

Chapter: 5 Results and discussion

This chapter is made up of descriptive statistics, assumptions of multiple linear regression analysis, multiple regression result (ROA), multiple regression result (ROE), model summary, analysis of variance. Furthermore, it includes the list of financial institutions in Malaysia complying with CGCLI 2013.

Chapter: 6 Conclusions, limitations and recommendations

This chapter provides main findings of the thesis, conclusion of the study, contribution to knowledge and recommendations, limitations and further research.

1.8 SUMMARY OF THE CHAPTER

This chapter presents overall information about the background of the study related to corporate governance and analyses reasons for its importance in the economy. It also includes the statement of problem and two research questions. Furthermore, it focuses on the significance of the study. In addition to that, a detailed information about the structure of thesis is also narrated.

CHAPTER 2

CORPORATE GOVERNANCE AND FINANCIAL INSTITUTIONS IN MALAYSIA – AT A GLANCE

2.1 INTRODUCTION

This chapter throws light on two major areas of importance to this study; corporate governance in Malaysia and structure of financial institutions in Malaysia. The first part of this chapter focuses on corporate governance, its historical overview and development of corporate governance in Malaysia. The development of corporate governance is presented from the stand point of various regulatory bodies in Malaysia. The second part of this chapter outlines a brief information about financial systems in Malaysia and corporate governance for financial institutions in Malaysia.

2.2 CONNOTATION OF CORPORATE GOVERNANCE

The term corporate governance was in existence much earlier, but it started to be extensively used in literature after 1990s (Brian, 2015). This is a comprehensive term, many studies, regulated bodies and authors define the term in their perception. This section includes implications of the term corporate governance, in different prospects. In simple words, CG refers to the process of managing the company. The following paragraphs provide detailed analysis of the concept and definition of CG.

The Cadbury Report (1992), titled 'financial aspects of corporate governance' set up in 1991 and chaired by Adrian Cadbury, published draft version in May 1992. The revised and final version was issued in December of the same year, it describes corporate governance as 'the system by which companies are directed and controlled'. Corporate governance is the system by which business corporations are directed and controlled (OECD, 1999).

Corporate governance is the system by which business corporations are directed and controlled stated by the organization for economic cooperation and development (OECD, 1999). According to Morin & Jarrel (2001) corporate governance is a framework which monitors and safeguards the concerned actors in the market (managers, staff, clients, shareholders, suppliers and the board of administration).

A set of standards and procedures through which a firm is run is called corporate governance (CG). Currently, there is no unanimously accepted definition of CG. The definition of corporate governance varies from country to country depending on national, cultural or legislative characteristics (Ramon, 2001). Although, there are different principles of CG all over the world, its ultimate aim is to control the management from pursuing their own interest at the investors' cost (Luo, 2007).

The term corporate governance is defined as association between business executives and stakeholders which is formulated by public agencies through market practices and principles (Oman, 2001). The Ministry of Finance, Singapore (Corporate Governance, 2001) has introduced a similar definition; according to them, it is a combination of procedures and frameworks of running an organisation while at the same time guarding the interests of all stakeholders.

Adams and Mehran, (2003) viewed that the CG is the mechanism through which 'stakeholders monitor the management and insiders to safeguard their own interests' (stakeholders includes shareholders, creditors, employees, clients, suppliers, the government and the society in general). According to OECD (2004) this definition is augmented as 'the corporate governance structure specifies the distribution of right and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders and spells out the rules and procedures for making decision on corporate affairs'.

Bank for International Settlements (BIS) is the world's oldest international financial organization established in the year 1930; it has 60 members central bank around the

world. As per the BIS Guidelines on Enhancing Corporate Governance for Banking Organisations (2006), corporate governance involves the manner in which the business and affairs of an individual institution are governed by its board of directors and senior management, affecting how an institution: sets corporate objectives, (including generating economic returns to owners), runs the day-to-day operations of the business; considers the interests of recognized stakeholders, aligns corporate activities and behaviors with the expectation that the institution will operate in a safe and sound manner, and in compliance with applicable laws and regulations; and protects the interests of depositors.

According to Ahuja (2007) corporate governance is a promotion of corporate fairness, transparency and accountability. The ultimate aim of corporate governance is, of course, to improve the company's competitiveness to raise the shareholder value (Humera, 2011).The Malaysian code on corporate governance 2012 defines the term corporate governance as 'the process and structure used to direct and manage the business and affairs of a company towards enhancing business prosperity and corporate accountability with the ultimate objective of realizing long term shareholder value, whilst considering the interests of other stakeholders'. Corporate governance is about building creditability, ensuring transparency and accountability and maintaining effective channels of information disclosure (Onakova et al. 2012). International finance corporation (IFC), a member of the World Bank Group (citation 2016), defined it as the structures and processes by which companies are directed and controlled.

2.3 HISTORICAL OVERVIEW OF CORPORATE GOVERNANCE

The history of corporate governance refers to the development of the concept of corporate governance throughout the years. CG is defined by contemporary sources as a structure, it is concerned about mechanisms and sequence of systematic activities by which the corporations are controlled and directed. The history begins with the time when human being started handling money and conduct of business and commerce.

During 1600s, a Royal Charter was granted to The Company Merchants of London trading into the East Indies. The company started with 218 members and was governed by court of directors. The governance structure consisted court of proprietors and the court of directors. The court of directors was the executive body and was responsible for running the company. In such a way, the governance originated into the business environment. Adam Smith's (1776) 'Wealth of nation' is the major source for research on corporate governance. In his book, he predicts that among other things, trade of Joint Stock Company is always managed by court of directors. Jenson and Mackling (1976) predicts that the mangers are the agents to work for maximizing the return to shareholders, who are the principals.

The Anglo-American (one-tier system) and the Franco-German (two-tier) are the two most common corporate governance models in practice in today's business world. The board of directors has usually the highest authority in the firm one-tier system. This system, which is in practice in the USA and the UK, is also commonly known as the 'market model' or 'shareholder model' because it is heavily dependent on private shareholders. In comparison with Franco-German system, the framework of ownership in Anglo-American countries is widely scattered among a number of diverse individuals and institutional investors (Li, 1994).

On the other hand, Germany and Japan have the two-tier system which looks after the interests of all stakeholders. Banks are the biggest source of funds in European nations, unlike the USA, and some other countries. Li (1994) asserts that cross-shareholding among companies is possible in the two-tier system, as the ownership structure in every single firm is often concentrated within a small number of directly related companies, banks and families. There are often two boards, which are the supervisory board and the managerial board, in most public listed companies in a two-tier system. All important decisions are made by the supervisory board while day-to-day strategies are carried out by the managerial board.

John and Senbet (1998) point out that shareholders expect that the board of directors would supervise the affairs of the company on their behalf. Many countries across the

world have now introduced codes of best practices in corporate governance, as corporate governance reforms became the utmost priority after the economic crisis in Asia in 1997. There is a growing awareness that governance practices such as efficiency and accountability result in better control within the organization. An efficient governance structure cannot function without effective system of checks and balances. If the company possesses a potent board of directors, then the shareholders would feel safe and comfortable (Ng, 2005). In an Anglo-American system which is also known as shareholder model, board of directors is the most important body with the highest authority to supervise the management in the company (Abdullah, 2004). Malaysia's close historical links to the UK could be the reason for following the UK Combined code on corporate governance (Ow-Yong & Guan, 2000).

They anticipate that the board would lead the firm to attain its projected targets in the market and while doing so it would not only manage the administrative activity, but also guard their interests (Abdullah, 2004). However, the significance of external directors on the board cannot be denied. According to Cohen et al. (2004), apart from company's own system of governance, dealings among member who are responsible of governance are affected by outside members for instance, regulators, legislators and financial analysts. It can be implied that minority interests of the shareholders could only be fully guarded by the legal regime (La Porta et al., 2000).

In any country, functional corporate governance structure is not possible without a suitable legal, regulatory, and institutional base as stated in OECD's principles of corporate governance 2004. Government should support and enforce the regulations to make sure that corporate governance succeeds. It should also show intolerance towards any mistreatment of minority shareholders, and help in protecting their interests as well (OECD, 2004). In some countries, corporate governance codes were rather issued to meet the legal requirements than by desire to improve the governance practices (Zattoni & Cuomo, 2008). According to McKnight et al. (2009), shareholders have now access to bigger information asymmetry matters, which has only been possible through more and more compliance with recommended governance frameworks. It sends a strong signal to the shareholders that accountability and transparency are being taken very seriously in the company. However, it remains to be

seen how good governance affect agency costs. Good governance codes, varying in composition, has begun to emerge all over the world.

2.4 DEVELOPMENT OF CORPORATE GOVERNANCE IN MALAYSIA

There had been growing awareness regarding good corporate governance in Malaysia as early as 1993. During early 1993, Malaysian government initiated various measures to create a world class capital market. Initiating the process, the listing requirement of companies was revised and it was made mandatory for all public listed companies to form an audit committee by August 1, 1994. Development of corporate governance in Malaysia passes various stages and a number of events. The classification of the various development stages of Malaysian corporate governance is presented below under different headings arranged chronologically.

Table 2.1: Timeline of Malaysian Corporate Governance Development

1965	Companies Act 1965 (Revised - 1973)
1983	Securities Industries Act (SIA) 1983
1993	Securities Commission Act (SCA) 1993 and Securities Commission Malaysia (SC) 1993
1998	Finance Committee on Corporate Governance (FCCG) March 1998
1999	Finance Committee Report on Corporate Governance (Report) March, 1999
2000	Malaysian Code on Corporate Governance – 2000
2000	Minority Shareholders' Watchdog Group (MSWG) – August 2000
2001	Companies Commission of Malaysia Act 2001
2002	Companies Commission of Malaysia 2002
2007	Malaysian Code on Corporate Governance (Revised 2007) [By The Securities Commission Malaysia (SC)]
2012	Malaysian Code on Corporate Governance 2012 [The Securities Commission Malaysia(SC)]
2013	BNM's Guidelines on corporate governance for licensed financial institutions
2017	Malaysian Code on Corporate Governance 2017

2.4.1 Companies Act 1965 (Revised - 1973)

While discussing the development of corporate governance in Malaysia, the company Act 1965 and revised company Act 1973 occupies a prominent role. Part V and Division 2 of this act focuses on the information related to management and

administration of companies under the sub heading of directors and officers. Further, it deals with the number of directors required for the company and their qualifications. Functions of directors are also discussed in the act. These acts are fundamental for formulation of corporate governance for this country.

2.4.2 Securities Industries Act (SIA) 1983

Securities Industries Act 1983 makes provisions mainly related to stock exchange and persons dealing in securities. It also mentions certain offences relating to trading in securities. This act indirectly insists governance in companies. Further, this act provides information related to directors, stock exchange and company. This is one of the acts introduced to initiate the ground work of corporate governance development in Malaysia.

2.4.3 Securities Commission Act (SCA) 1993 and Securities Commission Malaysia (SC) 1993

In general, the term security commission stands for the government department and agency which is responsible for financial regulations and securities within the country. The securities commission in Malaysia is a statutory body delegated with the responsibility of regulating and systematically developing capital markets in Malaysia.

The Malaysian securities commission was established on 1 March 1993 under the Securities Commission Act (SCA) 1993. Malaysian Securities Commission (SC) also put strong emphasis on good governance by moving from a merit-based to a disclosure-based regulatory regime in 1995 (Haniffa, 2002). One of the main functions of SC is to regulate all matters related to securities and companies especially regulations. These regulations contributed for protecting the investors. The aim of setting up the SC in March 1993 was to carefully examine the legal structure governing the business sector (Wan Hussin & Ibrahim, 2003). Further, the act focused on to take all measures to maintain the confidence in the securities and derivative markets by ensuring adequate protection for such investors through regulations.

2.4.4 Finance Committee on Corporate Governance (FCCG) March 1998 and Finance Committee Report on Corporate Governance (Report) March, 1999

Financial crisis of 1997 is one of the important reasons for establishment of Finance Committee on Corporate Governance (FCCG) in Malaysia. During the period of financial crisis, the composite index of stock exchange fell tremendously from 1,077.3 points in June 1997 to 262.7 points in September 1, 1997, during the same period approximately U.S. $ 225 billion of share values were wiped off (Ariff M. & Abubakar S. Y. 1999). In the aftermath of financial crisis in 1997, FCCG was constituted with the aim of revising and strengthening the CG framework. This committee comprised of government representatives and also important people from the Industry. Initially the committee's assignment was to identify faults in CG and construct sound structure for it.

The main aim of FCCG was quickly identifying and dealing with weakness highlighted by the crisis in the then existing governance framework. This committee findings were reported in the form of Finance Committee Report on Corporate Governance in March 1999; the report recommended the introduction of the Malaysian Code on Corporate Governance, having been spearheaded by industry. In order to raise awareness about good governance in the business sector, the committee launched the Malaysian Institute of Corporate Governance (MICG) in 1999. Besides its main function of promoting good corporate governance, the institute also supplies a forum for various stakeholders to interact and discuss business problems.

2.4.5 Malaysian Code on Corporate Governance – 2000 [By Finance Committee on Corporate Governance]

Malaysian Code on Corporate Governance (MCCG) 2000 had put forward numerous recommendations to improve the transparency of public listed companies. Most recommendations, which were accepted by Bursa Malaysia, were put into practice in January 2001. After 30th June 2001, it was made mandatory for all listed firms to include the statement of corporate governance, a statement of internal control, composition of the board of directors, composition of audit committee, quorum of

audit committee and any additional statements by the board of directors in their annual report.

It can be stated without hesitation that the board of directors plays the most important role in ensuring good corporate governance in the company. This was acknowledged as the first principal under Part 2 (AA) of MCCG 2000. According to the MCCG, a well-balanced board is vital for effective management and good corporate governance. A well-balanced board should have equal number of executive directors and non-executive directors, including independent non-executive directors. No single group or individual should dominate the decision-making process. Non-executive directors have to possess deep knowledge and expertise in their domain, and have to be highly qualified to make independent decisions. One of the MCCG's recommendations also highlighted the need for separating the roles the CEO and chairman, though the Bursa Malaysia does not emphasise it. Furthermore, Board of directors is expected to highlight the best corporate practices to the staff annually, and maintain a strong internal control mechanism. They should also be well aware of potential business risks, and their preventive measures.

2.4.6 Minority Shareholders' Watchdog Group (MSWG) – August 2000

The creation of the Minority Shareholder Watchdog Group (MSWG) in 2001 was an important milestone, which stressed active shareholder participation in company affairs. MSWG mainly looks after minority shareholders' interests and protects them from majority shareholders' harassment, it also deals with preserving shareholder rights, minimising risks to shareholders and ultimately enhancing value to the capital market. The MSWG represents the leading institutional funds in Malaysia (Abdul Wahab et al, 2007).

2.4.7 Companies Commission of Malaysia Act 2001 and Companies Commission of Malaysia 2002

The Companies Commission of Malaysia is a statutory body which was formed in 2002 under the Companies Commission of Malaysia Act 2001. The main aim of this

body is to serve as an agency to corporate companies and registered businesses in Malaysia. Further it serves the public by providing them with company and business information. It launched e-info services through this public can obtain company information via its website. It is one of the leading authorities for the implementation of corporate governance in Malaysia; the commission also concentrates on monitoring and enforcing activities to ensure the business registration and corporate legislation compliance.

2.4.8 Capital Market Plan 1 (CMP) February 2001 [by The Securities Commission Malaysia (SC)]

Another positive step in this regard was drafting the Malaysian Capital Market Master Plan (CMP). The government showed its willingness and determination to fully carry out the recommendations made by the report on corporate governance when it launched CMP in February 2001. In total, 152 proposals were made by CMP, and ten were regarding the legal framework for the capital market. The recommendations were to be carried out during the next ten years. The proposals that dealt with the capital market emphasised on corporate governance. Furthermore, in order to speed up the corporate law reforms, Corporate Law Reform Committee was founded, in August 2003. It proved to be the turning point in corporate history of Malaysia, when the committee listed corporate governance issues as its most important priority. It was realised that good corporate governance is a key to economic success.

2.4.9 Malaysian Code on Corporate Governance (Revised 2007) [By the Securities Commission Malaysia (SC)]

The Malaysian Code on Corporate Governance (Code), first issued in March 2000, marked a significant milestone in corporate governance reform in Malaysia. It underlines the best principles and practices of CG. The mandatory reporting of compliance with the Code has enabled shareholders and the public to assess and determine the standards of corporate governance by listed companies. The Malaysian Code on Corporate Governance as revised in 2007 shows the consistent linkup efforts between industry and the Government.

2.4.10 Malaysian Code on Corporate Governance 2012 [The Securities Commission Malaysia (SC)]

The main aim of MCCG 2012 is that the listed companies in Bursa Malaysia should comply with almost all the principles of corporate governance. MCCG 2012 expects all the companies should adopt all of the principles of the corporate governance and its recommendations. The listed companies should mention in their annual reports to what extent the principles and recommendations are adopted. All the principles and recommendations may not fit all companies, in such a case companies should also explain the reasons of non-compliance. The listed companies should issue their corporate governance disclosures of the financial year 1 July 2012 to 30 June 2013 which should be published in 2013.

To enhance the effectiveness of the corporate governance framework of MCCG 2007, MCCG 2012 framework adopts a new structure with cleared information which allows companies for simpler reading. The recommendations are specific standards that contribute towards the principles. The MCCG 2012 includes some of the best practices in CG from the 2007 Code.

2.4.11 Guidelines on Corporate governance for licensed institutions 2013 (GCGLI 2013)

These guidelines were issued by BNM in the year 2013, the primary objective of the guidelines is to promote the adoption of effective and high standards of corporate governance practices by licensed institutions and holding companies. A detailed information about guidelines is discussed in section 2.7 of the same chapter.

2.4.12 Malaysian Code on Corporate Governance 2017

The first code of corporate governance was issued by securities commission Malaysia (SC) in the year 2000. To improve the principles and recommendation this code was revised twice in 2007 and 2012. MCCG 2012 has eight broad principles and 26 specific recommendations to be aligned with business practices and market development. In order to enhance CG practices, the Securities Commission Malaysia (SC), released the proposed draft on Malaysian Code on Corporate Governance 2016

(MCCG 2016) for public consultation. The new approach aims to encourage progression, and emphasis on conduct and outcomes from corporate governance practices. The comments and feedback of the public from proposed draft of MCCG 2016 has been largely incorporated in MCCG 2017 and the new code on corporate governance was issued on 26th April 2017, which takes effect immediately. MCCG 2017 applies to all public companies which are required to disclose in their annual report of the financial year 2017. During consultation MCCG reinforces apply or explanation an alternative concept. MCCG 2017 provides greater focus and clarity on intended outcomes for each practices. During the research period the updated corporate governance in Malaysia was MCCG 2012 hence this study uses MCCG 2012.

2.5 INSTITUTIONAL CONTRIBUTION IN MALAYSIAN CORPORATE GOVERNANCE

The following three institutions mainly contributes input related to corporate governance for business sector.

i. Malaysian Institute of Corporate Governance (MICG)
ii. Malaysian Accounting Standard Board (MASB)
iii. Malaysian Institute of Accountants (MIAs)

2.5.1 Malaysian Institute of Corporate Governance (MICG)

In order to raise awareness about good governance in the business sector, the committee launched the Malaysian Institute of Corporate Governance (MICG) in 1999. Besides its main function of promoting corporate governance, the institute also supplies a forum for various stakeholders to interact and discuss business problems.

2.5.2 Malaysian Accounting Standard Board (MASB)

In 1997, Malaysian Accounting Standard Board (MASB) was established under the Financial Reporting Act 1997. In Malaysia, MASB and Financial Reporting Foundation (FRF) are independent authorities to develop and publish accounting and financial reporting standards that can match the finest world practices. All companies

have to meet the standards given by MASB. The suggested accounting standards mentions about corporate governance.

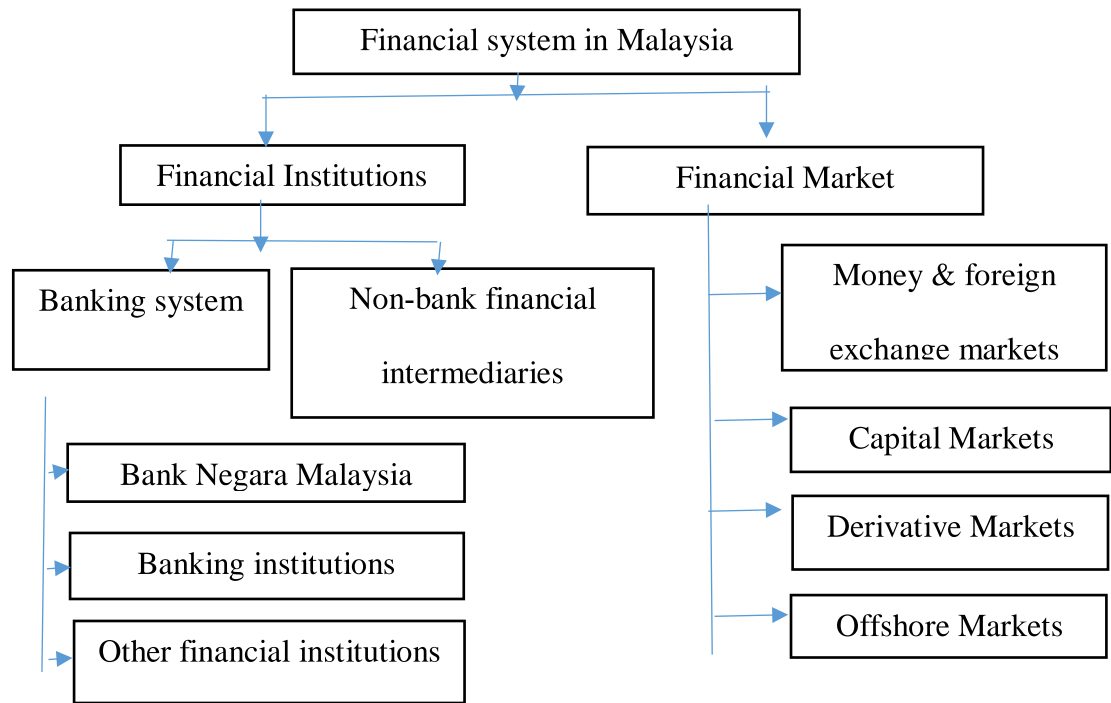
2.5.3 Malaysian Institute of Accountants (MIAs)

In 1967, Malaysian Institute of Accountants was established under the Accountants Act 1967. MIA has dual responsibility to regulate and develop accountancy profession in Malaysia. It is the national accounting body that strengthens support, integrity, provide high quality training and services and enhance interest of the profession in Malaysia. In order to ensure public and stakeholders, trust of accountability MIAs maintains highest standard at all time. MIAs plays a significant role in developing and advancing the global accounting profession through its involvement in organizations such as the International Federation of Accountants (IFAC) and the ASEAN Federation of Accountants (AFA).

2.6 FINANCIAL SYSTEM IN MALAYSIA

The financial system in Malaysia is built on a solid foundation for the rapid economic growth and diversity of rapid industrialization. The Malaysian financial system is more comfortable and easy to access. It has diversified range of institutions that works for the needs of different sectors of the economy. The two broad classification of Malaysian financial system is, financial institutions and financial market. The financial institutions are further classified into banking system and non-bank financial intermediaries. The financial market comprises four different sections which are money and foreign exchange markets, capital markets, derivative markets and off shore markets.

The financial system in Malaysia is regulated by the central bank (BNM) and Ministry of Finance (MOF). Apart from these two, other governing bodies of the financial system include the Securities Commission and the General Insurance Associate of Malaysia. The information about classification of financial system in Malaysia is presented in Figure 2.1.



Source: BNM website

Figure 2.1 Financial System in Malaysia

2.6.1 Financial Institutions

Financial institutions provide a wide range of services in the economic system. They play a key role in the smooth functioning of economy (Jeffrey Carmichael and Michael Pomerleano, 2002). The surplus resources of individual and companies are rooted through the financial institutions into resource deficits. Financial institutions are an establishment that conduct and regulates financial transactions such as loans and deposits, investment, currency exchanges. The major activities of the economy run (deposit and loans) through financial institutions. Financial institutions in Malaysia encompass a broad range of business operations. The financial operators occupy a pre-dominant role in economy. The citizens and the government of a country depends on the financial institutions in the country.

The financial institutions in Malaysia are classified into two major sections: banking system and non-bank financial intermediaries. The details about these systems are discussed in the following paragraphs.

2.6.1.1 Banking system

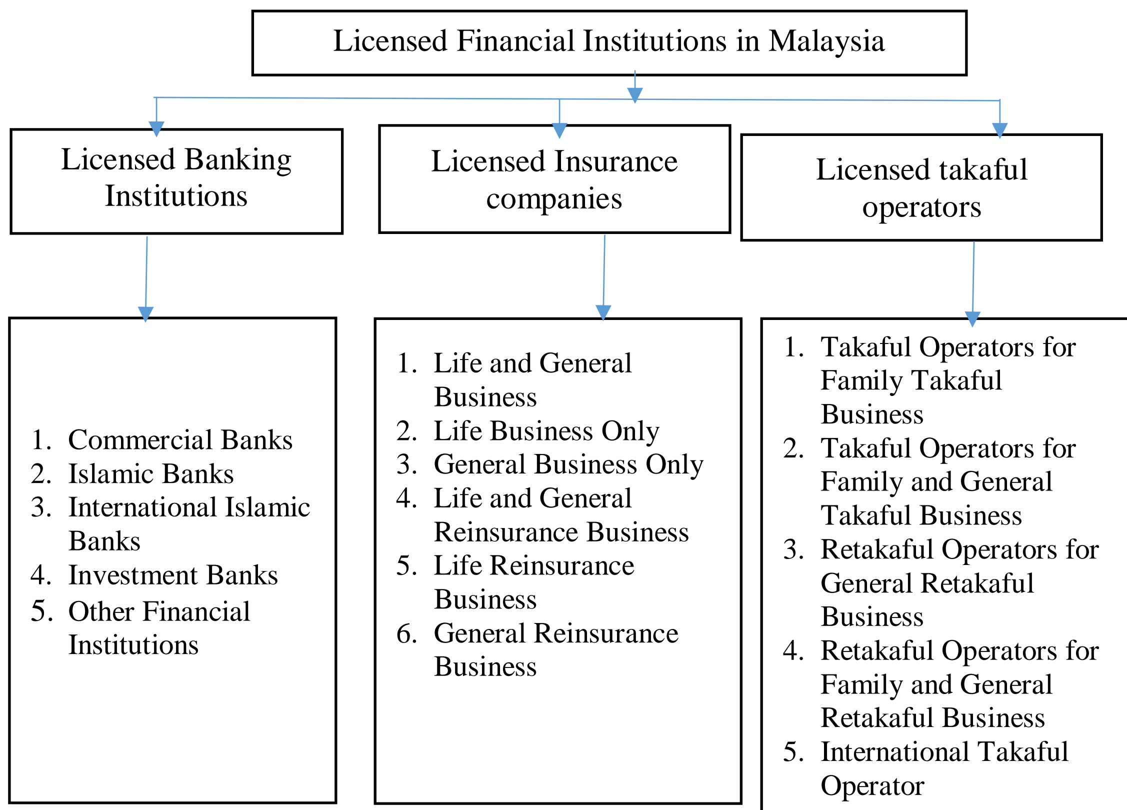
Banks play a very important role in the economic development of every nation. Banks are the main stimulus of the financial system of the country. According to Thorsten, Asli and Ross, (2009) the banking system occupies pre-dominant role in the financial system in most countries especially in emerging and developing countries. The banking system in Malaysia comprises of Bank Negara Malaysia (The Central Bank), Banking institutions and other institutions.

a. Bank Negara Malaysia

BNM is the central bank of Malaysia, it is called as Bank Negara Malaysia in local language (Malay) and is abbreviated BNM. BNM was founded on 24 January 1959. The major objectives of BNM is to issue currency and keep reserves to safeguard the value of the currency, to act as adviser of banks and government, to promote monetary stability and sound financial structure and influence credit situation for the benefit of the country.

a.1 Licensed Financial Institutions in Malaysia

According to BNM official website (http://www.bnm.gov.my/), the financial institutions are presented in a different form viz. Licensed Financial Institutions in Malaysia. According to BNM, they are further classified into three types: licensed banking institutions, licensed insurance companies and licensed takaful operators.



Source: BNM website

Figure 2.2 Licensed Financial Institutions in Malaysia

b. Banking Institutions

The term banking institution is a wide term to define, in general, it is the combination of commercial banks, finance companies, merchant banks and Islamic banks which now or may hereafter be organized under the law of the country. Banking institutions can mobilize the deposits from the general public and companies and make loans to the needy people in the country. The banking institutions in Malaysia comprises of commercial banks, finance companies, merchant banks and Islamic banks.

Commercial banks play a vital role to attain stable prices, high level of employment and sound economic growth. They make funds available to meet the needs of individuals, businesses and the government. According to Malaysian Banking Act 1973, a bank is defined as 'any person who carries on banking businesses. Banking business means 'the business of receiving money in current or deposit accounts, paying

and collecting cheques drawn by or paid in by customers, and making advances to customers, and includes such other business as the central bank with the approval of the finance minister'. The main functions of commercial banks are mobilization of savings from the general public, making provisions to their customers to make payments and receive money, granting loans and advances, financing of the government, banking facilities and services etc.

Finance companies in Malaysia are second largest group of deposit taking institutions. There are currently 15 finance companies functioning in Malaysia. The main business of finance companies is receiving deposits, lending of money, leasing business and any other business specified and approved by BNM. Finance Companies Act 1969 has empowered the central bank to supervise the activities and operations of finance companies.

Investment banks are incorporated as public companies under the Companies Act, 1965. They play a role in the short-term money market and capital raising activities including financing, specializing in syndication, corporate finance and management advisory services, arranging for the issue and listing of shares, as well as investment portfolio management. There are currently 11 merchant banks in Malaysia. Just like commercial banks and financial companies, investment banks have to maintain statutory reserves and liquidity ratios prescribed by the central bank.

The banking activities of Islamic banks are based on Syariah principles (the Islamic principles). The first Islamic bank established was Bank Islam Malaysia Berhad, which commenced operations on 1 July 1983. On 1 October 1999, a second Islamic bank, namely Bank Muamalat Malaysia Berhad was established. Apart from Islamic banks, other financial institutions also offer Islamic banking services through the "Islamic Banking Scheme". In terms of products, all Islamic banking entities are offering banking products based on the Islamic principles.

c. Other financial institutions

The other financial institutions include discount houses and representative offices of foreign banks. Discount houses are specialized in short term money market operations. The first discount house in Malaysia was established in December 1963. The most important function of discount houses is the acceptance of short term funds from the banking, private sector and public authorities, and the investment of such funds in treasury bills and government securities, bankers' acceptances and commercial trade bills; thereby enabling them to adjust their liquidity positions whenever required. The BNM, through the publishing of "Establishment and Operations of Representative Offices in Malaysia" (2015) stated information about representative offices of foreign bank as below:

> "This policy document outlines the requirements for the establishment and operations of representative offices of foreign institutions whose businesses correspond, or are similar, to the following businesses: (a) licensed business under the Financial Services Act 2013 (FSA) and the Islamic Financial Services Act 2013 (IFSA); (b) insurance broking business, money-broking business and financial advisory business under FSA; and (c) takaful broking business and Islamic financial advisory business under IFSA".

All banking institutions offered basic saving account and basic current account to all Malaysians and permanent residents. The accounts enable to perform basis transactions with free or minimum charges. Along with some financial institutions financing amount up t RM 50,000 to self-employed and micro enterprises without any collateral securities. To promote saving habit financial institutions accept micro saving with favourable terms particularly from low income group. Some insurance and takaful operators are offering mocroinsurance policies for low income households against to meet unexpected unfavorable events.

2.6.1.2 Non-bank financial intermediaries

Non-bank financial intermediaries are important segments of the financial system of the country. In Malaysia, the non-bank financial intermediaries comprise provident and pension funds, insurance companies (including Takaful), development finance institutions, savings institutions, national savings bank, co-operative societies and

others include unit trusts, pilgrims fund board, housing credit institutions, Cagamas berhad, credit guarantee corporation, leasing companies, factoring companies and venture capital companies. The non-bank financial intermediaries mentioned above are supervised by various government departments and agencies. Non-financial institutions are closely linked with financial institutions, since as a deposit-taking institution it is subject to the supervision and control Bank Negara Malaysia continues to control them.

2.6.2 Financial Market

Financial market is a market to provide the facilities to the people to trade financial securities, commodities and other fungible items. In Malaysia, various efforts have been taken to develop the financial market. In developing the domestic capital market, various key initiatives are implemented. The initiatives were focused on creating facilitative regulatory environment, market infrastructure, continuous market development, liquidity and ongoing liberalization of foreign exchange policies. BNM established various segments to the development of financial market in Malaysia which are Fully Automated System for Issuing/Tendering (FAST), Islamic Interbank Money Market website, BondInfoHub, Cagamas Berhad, RAM Holdings and Malaysia Rating Corporation Berhad.

This study examines the impact of corporate governance on the financial performance of financial institutions. Financial market is not a part of financial institutions so this study exclude financial markets for analysis.

2.7 CORPORATE GOVERNANCE FOR FINANCIAL INSTITUTIONS IN MALAYSIA

Financial institutions in Malaysia have always played an important role in stimulating economic growth and development. The functions mainly concentrate on capitalization and improving the savings potentiality. The investors and public must believe the financial institutions otherwise the savings is questionable. The faith of investors is based on the financial intuitions following the guidelines of legal bodies and BNM. This study focuses on corporate governance guidelines issued by BNM on

2013. Guidelines on corporate governance for licensed institutions 2013 came into effect 19 June 2013. The following paragraph discussed about the guidelines in detail.

2.7.1 Overview and objective of the GCGLI 2013

The primary objective of the guidelines is to promote the adoption of effective and high standards of corporate governance practices by licensed institutions, holding companies and other financial institutions specifically mentioned by BNM. This guideline is applicable to all the licensed institutions, which means institutions which are licensed under Banking and Financial Institutions Act 1989 (BAFIA), such as, commercial banks and investment banks and the holding companies which hold 51% or more shares in institutions licensed under the BAFIA 1989. The main objective of the guidelines is to set out the broad principles and minimum standards as well as the specific requirements for sound corporate governance expected of financial institutions and holding companies in Malaysia. The guidelines are issued in pursuant to sections 56, 57 and 126 of the BAFIA.

2.7.2 Alignment with other CG codes

The BNM guideline includes broad principles, standards and requirements. These guidelines are aligned with principles of various corporate governance codes which are as follows:

a. The Malaysian code on corporate governance
b. The BIS guidelines on “Enhancing corporate governance for Banking organizations” and
c. Other international best practices on corporate governance.

2.7.3 Fundamental concept of guidelines

The guidelines are formulated on the basis of fundamental concepts of responsibility, accountability and transparency with great emphasis on the role of the board and management. The guidelines are insisting minimum standard and specific requirement.

Further, the guidelines contain broad principles dealing with a) board matters b) management oversight c) accountability and d) transparency.

2.7.4 Applicability of guidelines

Specifically mentioned BNM guidelines are applicable to specified institutions such as i) licensed institutions ii) holding companies and iii) any other institution specified by BNM. Holding company is a company that holds 51% or more interest in the shares of an institution licensed under the Banking and Financial Institution Act 1989 (BAFIA) and other companies approved by BNM. The licensed institutions refer to institutions which are licensed under BAFIA viz, commercial banks, investment banks and other financial institutions mentioned by BNM.

2.7.5 Guidelines Compliance Requirement

The guidelines specifically mentioned that all the licensed financial institutions are expected to comply and observe the guidelines. In addition to that, all the financial institutions disclose any non-observance of the guidelines in the annual report, and provide necessary explanation for the non-observance and also provide sufficient explanation and alternate measures taken to comply with the principles of guidelines.

2.7.6 Guidelines on Corporate Governance for Licensed Institutions (GCGLI) 2013 - Principles

GCGLI 2013, part 2 shows the guidelines comprised 14 principles, all these principles include various paragraphs and are sequentially numbered (Annexure 1).

2.7.7 Study variables and guidelines

Audit committee is one of the variables of the study, it is clearly mentioned in the GCGLI 2013 Part 2, principle 1 and para 2.18 of the guideline (Annexure 2) page number 10 that the board is required to establish various committees. Audit committee is one which the board is required to establish. Further paragraph 2.18 of the guidelines assigned the readers to refer the appendix 2 of the guidelines for detailed information

about audit committee. Appendix 2 of the guidelines clearly stated audit committee related information (Annexure 3).

Board composition is the second variable of the study. This variable is clearly pointed out in part 2, principle 2 and para 2.28 of the GCGLI 2013 in page number 13 (Annexure 4). GCGLI 2013 mentioned that one third of board members of the licensed financial institutions should be independent. Further BNM has concerns about more number of independent directors for the effective functioning of board activities.

Board size is the third variable of the study, the details about this variable is given in the GCGLI 2013. It is mentioned in the guidelines over part 2, principle 2 and para 2.19 to 2.21 (Annexure 5).

2.8 SUMMARY OF THE CHAPTER

This chapter presents the meaning and historical development of corporate governance followed by corporate governance development in Malaysia. This chapter then describes the institutional contribution in Malaysian Corporate Governance, Banking, and non-bank financial intermediaries in detail. It further explains the corporate governance for financial institutions in Malaysia with special reference to GCGLI 2013.

CHAPTER 3

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

3.1 INTRODUCTION

This chapter presents the literature review of the study and hypotheses development. Literature review consists of information about agency theory and its relevance to corporate governance, in general and Malaysia in particular. The second part of this chapter is hypothesis development progressed from the literature review.

3.2 AGENCY THEORY

The present study is mainly based on agency theory. Agency theory explains the relationship between principals and agents in the business environment. According to Jensen and Meckling (1993), an agency relationship is a contract under which one or more (principals) engage another person (the agent) to perform some services on their behalf, delegating some decision-making authority to the agent. This theory is concerned on resolving the problems that can exist in agency relationship due to unaligned goals or different level of risks. In general, the agency relationship in finance occurs between shareholders (principals) and company executives (agents). Further, agency theory narrates how best organized relationships between a party determines the work and the other party does the work. In this relationship, the principal appoints agent to do the work on behalf of the principal.

The agency theory is used as a theoretical framework for this study and used to investigate the relationship between corporate governance mechanism and financial performance of financial institutions in Malaysia. This study investigates three characteristics of corporate governance that have been identified as possibly having impact on return on asset and return on equity. The agency theory is the dominant theoretical viewpoint applied in corporate governance studies (Shleifer and Vishny, 1997). Agency theory is largely used in accounting research (Schillemans and Busuioc, 2015). Maijoor (2000) also claims that corporate governance promotes firms' internal control system by improving regulations in accountability issues which

are, to a great extent, related to resolving agency problem. The relationship between employer-employee, constituents-elected representative, state-ambassador are some forms of agency relationship. In the principal-agent relationship, the principal pays compensation such as salaries, bonus, and stock options to the agent for their service and also allows them to make optimal decisions. Corporate governance is the system by which companies are directed and controlled. Boards of Directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and auditors and to make sure that an appropriate governance structure is in place.

The responsibilities of the board include setting the company's aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. There are many players in the system of corporate governance, where the government and other regulatory agencies provide the platform through legislations and rules. On the other side, the board of directors, auditors, shareholders, financial institutions, accounting professionals, company secretaries and employees play their individual roles for the proper governance. However, on the wake of changes in the economy, their traditional roles might need some fine tuning.

In the corporate world, shareholders delegate managers to do business on their behalf. Managers are accountable to the shareholders for the proper utilization of economic resources of the business. Even in earlier studies such as Berle and Means (1932), it has been argued that a decentralized system of shareholders cannot properly constrain corporate managers to act in the shareholders' interests. The Agency theory has its roots in economic theory (Alchian & Demsetz, 1972). The shareholders are interested in maximizing firm value, whereas the managers are interested in enhancing personal wealth, job security and prestige; this leads to conflict of interests and increase agency cost (Jensen & Meckling, 1976). The author (Jensen & Meckling, 1976) also mentions that the main reason of agency problem is separation of ownership and control. There is a question of trust in financial analysis procedures, when there is an increasing conflict of interest between the principal and the managers. Sometimes, the managing authorities may have a tendency to divert the performance report into their own favour

(Othman and Zeghal, 2006). Conflict of interests between owners and managers results in agency problems (Epps & Cereola, 2008).

The basic issue, from an agency perspective, is how to avoid such opportunistic behavior (Macus, 2008). To rectify this conception of agency problem within corporate governance, principals can create a contract with the agent to take actions on cost that are in interest of the principal, without monitoring. The cost involved in this action is agency costs which involves incentives that will align executive self-interest with the interests of shareholders. In order to enhance firms' value and shareholders' wealth, the principal needs to monitor and control agent's activity; such controlling involves financial audits, systematic review of management and placing specific limit on decision making (Elsayed & Khaled, 2007). When the principal delegates some decision-making responsibility to the agents without any control, the agent will misuse the power for their own benefits at the cost of their principal (Chowdhury, 2004). However, some authors claim that the interests of managers and shareholders differ extensively given that managers are people who go in search of prestige, money and power over the company, and thus try to impose their personal goals on the company, unlike shareholders who just seek financial benefits (Garcia, 2008). Companies should seek to minimize these situations through solid corporate policy.

The creation of audit, nomination, and remuneration committees with more independent non-executives ensure proper use of incentives and high degree of monitoring of executive performance and decision making. To minimize agency problem, there are two steps such as monitoring and bonding. The loss incurred by these activities is called agency cost (Jensen & Meckling, 1993). The internal and external monitoring costs are incurred to minimize conflict of interest suffered by investors (Williams, Duncan, Ginter, & Shewchuk, 2006).

3.3 AGENCY THEORY AND CORPORATE GOVERNANCE

In agency relationship, principal appoints the agent to look after the business in favour of the investor. Sometimes agent act in his own interest, this conflict of interest leads

to information asymmetry and agency problem. When the interests of people who control the organizations differ from those who invest in the company, it leads to conflict of interest. Board of directors is the apex body of internal governance system and has a responsibility to prevent the opportunistic behavior of managers. Corporate governance can be used to change the rules under which the agent operates and restore the principal's interests. Corporate governance implies that companies should balance the interests of shareholders with stakeholders at all levels of organization. Good governance practices entail active participation of shareholders in the direct and indirect management of a corporation through the board of directors and an arrangement of productive checks and balances among shareholders, board of directors and management of corporations.

Farinha (2003) conducted the theoretical and empirical literature review to find out the true nature and consequences of corporate governance. The study tried to find out the reasons of conflict between the manager and shareholders in organizations with respect to ownership mechanism. The study found that major problem in organization arises with the principal and agent relationships, and a different approach of manager than the shareholders. Risk preference is also a major source of conflict between the principal and the agent. Shareholders are associated with the market risk and the risk of stock returns, whereas managers are always concerned with the company risk because their survival depends on it.

Filatotchev, Lien and Piesse (2004) studied the corporate governance and performance in publicly listed family-controlled firms in Taiwan. The authors argued that firms located in East Asia, operate with a distinctive culture and in different legal and institutional environments than the West and Europe. This study used agency and strategy research and concluded that these cultural differences may have a strong impact on governance-performance relationships. Novikova (2004) listed out major participative actors for the firms such as the board, the shareholders, the managers and the other stakeholders for the companies. The author defined the rules used in the institutions and procedures used to control the participant of the firm.

Based on the agency theory, effective corporate governance mechanism could enhance shareholders confidence by motivating managers to work on profit maximization for

the shareholders, reduce conflict of interest and agency cost (Idie, 2013; Masood, 2011; Judge, Naoumova, & Koutzevol, 2003; Gursoy & Aydongan, 2002). Agency problem can be reduced by the help of effective corporate governance mechanism which can be important in reducing the agency cost and the ownership problems in the firms (McColgan, 2001). Many previous studies have made significant contribution by analysing how CG has an effect on such conflict on interest between principal and the agent (Fama, 1980; Fama & Jensen, 1983; Tricker, 2009). Corporate governance will play a significant role in controlling conflict of interest among investors and managers in slow growth firms and reduce agency cost (Jensen, 1986). With effective corporate governance mechanism, the corporate can control to assure executives to act in the best interest of investors (Syriopoulos & Tsatsaronis, 2012; Awotundum, Kehinde & Somoye, 2011; Bonazzi & Islam, 2007). Through effective corporate governance and internal and external mechanism, owners try to monitor and control the business activities and resolve agency problems (Shleifer and Vishny, 1997). Audit committee, board size, board composition are some of the significant internal control mechanisms existing to minimize agency problems. (Malik, 2012; Mulili and Wong, 2011; Saat et al., 2011; Paul, Friday, and Godwin, 2011; Srivastava, 2011). The agency theory has its roots in economic theory and it dominates the corporate governance literature (Uwuigbe, 2011).

Some Malaysian studies (Amir Ranjbar, 2009; Binti Yahya 2014; Tze San et al.2015) shows significant relationship with CG and financial performance. Hence, it is expected that an effective CG rules can have a significant result in financial institutions' financial performance in Malaysia. Joel and Dondjio, 2012 and Ik Yee Tan et al. 2016 used agency theory as a theoritical framework to study in Malaysian context to analyse CG and financial performance. This study applies agency theory to provide link between corporate governance mechanisms and the financial performance of financial institutions in Malaysia.

3.4 HYPOTHESIS DEVELOPMENT

3.4.1. Introduction

The Agency theory and theoretical framework presented above will be used to develop the testable hypothesis for the study. The hypotheses of this study are based on the

argument that good governance practices, namely audit committee, board composition and board size affect the financial performance of financial institutions. This study uses return on asset and return on equity as determinants to analyse the financial performance. The study further analyses the compliance of BNMs guidelines on corporate governance for licensed institutions, and based on literature, the hypotheses is later developed related to compliances.

By using independent, dependent and control variable the theoretical framework of the study is given below:

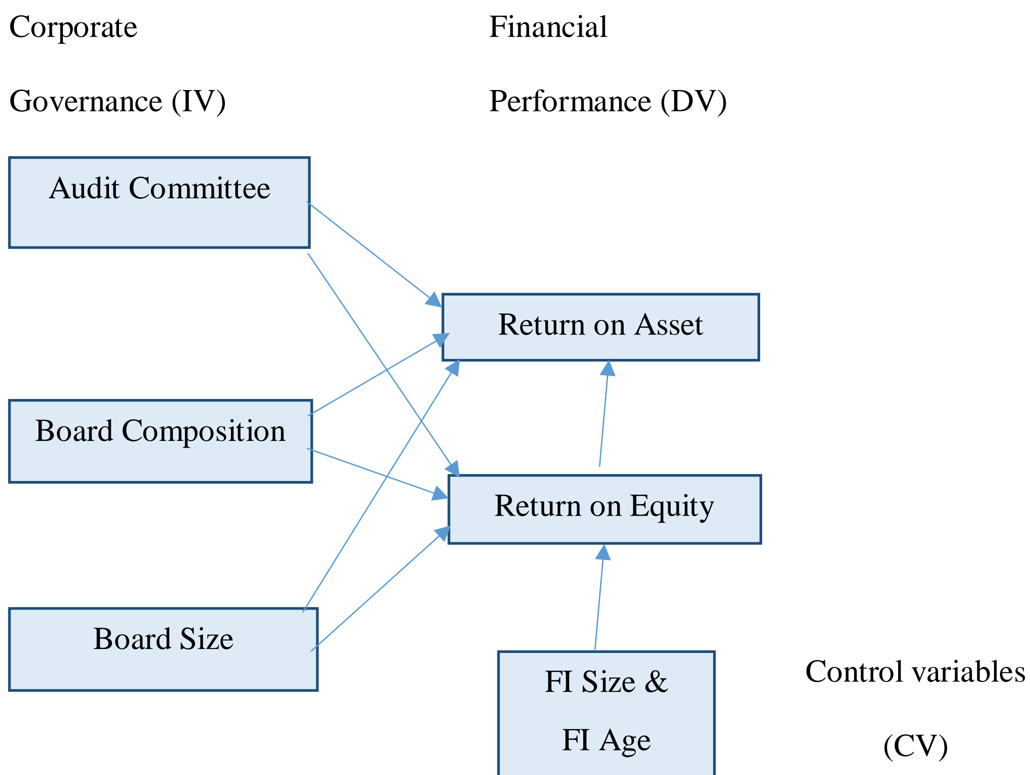


Figure 3.1 Theoretical Framework

3.4.2 Independent variable - Audit Committee

Audit committee is viewed as a committee established by and amongst the board of directors of the company for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer (Sarbanes Oxley Act 2002). In another view, Ayinde (2002) observes that the audit

committee is a standing committee established to enhance corporate accountability by working with the internal auditors and management to improve and strengthen the financial reporting practices of an entity and ensure proper conduct of corporate affairs in accordance with generally accepted ethical and legal standards.

To look after all internal and external functions of audit committee, this committee has three individuals among which one member must be have significant financial competence. This committee ensuring sufficient compliance with Securities and Exchange Commission (SEC) and Generally Accepted Accounting Principles (GAAP) standards.

One amongst the internal corporate governance mechanisms is audit committee. The principal objective of audit committee is to ensure that the financial statements and disclosures are prepared according to the legal requirements, and accounting standards set by the relevant professional bodies. The Sarbanes Oxley Act (2002) defines 'audit committee as a committee established by and amongst the board of directors for the purpose of overseeing accounting and financial reporting processes'. It is argued that audit committee can perform its functions efficiently, when it is able to operate independently, without managerial influences. In order to enhance their performance, audit committees continuously need to benchmark their performance against leading best practices and global trends.

Audit committees have been in existence since the year 1939 (Oghogho et al. 2013). However, there have been several criticisms as to the importance of audit committee in enhancing financial reporting. For the financial statement to be useful for decision making it must show the true and fair view of the company statements of financial position and performance. This can only be achieved through regular and periodic audit of the company financial statements as prepared by the auditors.

Higher levels of independence and expertise on board and audit committees increase firm value (Chan and Li 2010). Suitably qualified and committed independent audit committee acts as a reliable guardian of public interest (Abbott et al. 2004). Audit committee improves the quality of internal audit activities (Turley and Zaman 2004). The role of the audit committee is to appoint external auditors, communicate

with internal auditors, external auditors and managers of the company during internal control and audit process (Bouaziz 2012). This study also says that the independent directors in audit committee has positively significant with profitability. Previous studies have positive result with independent audit committee members on financial performance (Chand and Li, 2008; Aldamen et al. 2012; Al Matari et al 2012). These authors mentioned that the audit committee independence facilitates effective supervision of management activities. The independent members in audit committee is very essential to fulfil its supervising responsibility. Whereas Ghabayen (2012) also mentioned that the audit committee should be independent from the management board in order to fulfil the supervising function effectively. In Australia companies are advised to have minimum of three independent members in their audit committee with some dependent members. When the audit committee has more than 50% independent directors it is mentioned as highly independent audit committee, this will help to reduce agency problem and agency costs (Klein, 2002).

Krishnan (2005) finds that there is more number of independent audit committees members resulted with less internal control problems. Agrawal and Chadha's (2005) study find that the companies' boards or audit committees have lower number of independent directors with financial expertise. At the same time, the study is not significantly related to independence. Krishnan et al. (2011) finds the audit committee members with legal background to be associated with higher financial reporting quality.

An audit committee helps (i) to improve public confidence, (Gompers, Ishii, & Metrick) (ii) to provide financial report to directors, (iii) to ensure external audit independence. The composition and the size of audit committee is an important element of financial institutions to reduce the agency cost and conflict of interest that arise between the investors who are the principal, and management as agent. The audit committees should consist of independent non-executive directors, who are less likely to be influenced by the management, and therefore, can carry out financial reporting process more effectively (Shab Hundal 2013). According to BNM's guidelines on corporate governance for licensed institutions (GCGLI), 'the audit committee shall

comprise only of non-executive directors with at least three members, of which the majority should be independent directors. The committee should be chaired by an independent director. At least one member should have accounting expertise or experience in the field of finance'. In 1991, the Malaysian government encouraged the setting up of audit committee in listed firms to strengthen the financial reporting according to BNM's guidelines on corporate governance for licensed institutions stated in the principle about the audit committee.

The independent directors in audit committee are one of the corporate governance tools which protect shareholders' value by monitoring corporate activities (Ramano, Ferretti, & Quirici, 2012). It is generally agreed that all members or majority of the audit committee members should be independent non-executive directors (Cadbury, 1992). Weir et al (2002) investigated the internal and external governance mechanisms and their impact on the performance of 311 largest listed public companies in United Kingdom. Results indicated that independent directors in audit committee improve the financial management and its performance. The firm with higher percentage of independent directors in audit committee which have at least two meetings per year are less likely to issue fraudulent report Abbott et al. (2004). Klein (2002) indicates that reductions in audit committee independence are accompanied by large increases in fraudulent report. Malaysian studies (Abdullah et al. 2014; Yunos, R.M. 2014; Abdul Rahman, R., & Aeem Mohamed Ali, F. 2006) found positive association between audit committee independence and firm performance in Malaysian public listed firms.

Sun, Lan & Liu, 2014 found audit committee independence weaken the earning management activities in US firms.

Thus, in order to test the association between number of independent non-executive directors in audit committee and the financial performance of licensed financial institutions in Malaysia, the following hypotheses are formulated.

H1: There is an association between independent non-executive directors in audit committee and return on asset (ROA).

H2: There is an association between independent non-executive directors in audit committee and return on equity (ROE).

3.4.3 Independent variable - Board Composition

Board composition refers to the ratio of non-executive and executive directors on the board to monitor management. According to Enobakhare (2010), board composition is measured by the total number of directors brought from outside the company to sit on the board divided by the board size in a given period. In principle 2.28 of guidelines on corporate governance for licensed institutions by Bank Negara Malaysia, there should be an effective board composition with a strong independent element.

Although executive directors have valuable knowledge and skill in every day operations of the business, there is a need for independent non-executive directors who have knowledge of their own field and other businesses; as it clearly helps performance (Firth, Fung, & Rui, 2002). Agency theory also underlines that the higher proportion of independent non-executive directors in the board will increase transparency and encourage directors to disclose more information (Sheila, 2012). Many countries recommended companies should strengthen their board with more independent directors (Huse, 2005). According to Fields et al. (2003) independent non-executive directors may effectively influence the board's decision and also add value to the firm. Choe & Lee (2003) also mentioned, independent board members are highly recommended for effective management decisions. The opportunistic behavior of the insider may be slashed when the outside directors take part in the management. It is pointed out by Ramano et al. (2012) that more number of independent non-executive directors in the board results in lower financial fraud. Whereas, organizations found of financial reporting fraud are more likely to have a board of directors dominated by insiders (Farber, 2005; Song & Windram, 2004; Uzun, Szewczyk & Varma, 2004).

As per the agency theory, the executive directors and non-executive directors work as agents for the principals. Agency theory recommends the involvement of independent non-executive director to monitor managers as it minimizes agency cost (Williams et al., 2006). Independent non-executive directors in board can encourage the management to disclose more information to protect shareholders' interest and this will enhance the firm's performance (Chen & Jaggi, 2000; Gul & Leung, 2004; Cheng & Courtenay, 2006; Norita & Shamsulnahar, 2004). Moreover, Fama (1980) stated that independent directors had better control in monitoring and managing self-interest and opportunism. Chau & Gray (2010) investigated family ownership, board independence and voluntary disclosure in Hong Kong, concludes that the performance of company with independent directors would be better than company without independent directors. Yonca et al. (2010) found that the companies which have more independent directors perform well than the companies with less independent directors.

Peasnell et al. (2001) attempts to show that independent directors and audit committees reduce the manipulation of benefits. The authors argue that good corporate governance practices can reduce fraudulent activity and improve the quality of financial reporting. The results confirmed their predictions, since it was revealed that independent directors bring greater integrity to the financial information (less manipulated). Another survey by Bhagat and Black (1999) titled "The uncertain relation between board composition and firm performance" found no positive effective of independence directors in firm's financial performance.

On the other hand, Andres and Vallelado (2008) find that an excessive proportion of independent non-executive directors could damage the advisory role of boards. Eisenberg et al. (1987) argue that a board composed mainly of independent directors does not affect the quality of financial information. The authors reveal the existence of a negative and insignificant relationship between the higher percentage of non-executive directors, independent ones to be precise, and the presentation of financial information. Whereas, Haniffa & Hudaib (2006) state that there is no relationship between independent non-executive directors and performance. Krishna (2006) found that independent directors in board doesn't provide any impact financial performance.

Collins and Kothari (1989) while attempting to show evidence of a negative relationship between corporate governance, found a negative relationship between independent directors on the board and a higher quality of financial reporting. This study concluded that the inclusion of independent directors on the board is not sufficient to increase the quality of accounting information. In another work board with more executive directors successfully aligning of shareholders' interest than non-executive directors (Fernandes, 2005).

Kumar and Sivaramakrishnan (2008) mentioned when there is more independent directors it reduces corporate performance and shareholders' value. The above findings of Bhagat and Black agree with those of Klein (1998) in the study titled "Firm performance and board committee structure" resulted with more independent directors have no meaningful effect on firm performance, this author found a positive correlation between executive directors and firm performance.

When analyzing 75 listed companies in Malaysia, Zubaidah et al. (2009) found that board composition has a significant association with performance. Johari et al. (2008) found that even minimum composition of independent directors on board in Malaysian context has no adequate control over management. Abdul Rahman and Mohamed Ali (2006) concluded independent directors in board has no impact on earnings management in Malaysian companies. Foo and Zain (2010) studies the sample of 481 listed companies in Malaysia concluded that boards' independence leads to firm liquidity. Despite prior studies yielding inconclusive findings, this study still expects that independent non-executive directors will enhance the financial performance.

Thus, in order to test the association between independent non-executive directors in board and financial performance of licensed financial institutions in Malaysia, the following hypotheses are formulated.

H3: There is an association between independent non-executive directors in board and return on asset (ROA).

H4: There is an association between independent non-executive directors in board and return on equity (ROE).

3.4.4 Independent variable - Board Size

According to BNM's code, aligning with GCGLI 2013, the number of members in the board of directors plays an important role in overall effectiveness of the board. Board size should be kept to the very minimum in order to increase performance of a business. Based on guidelines (principle 2) on corporate governance by Bank Negara Malaysia, the board should determine the appropriate size of the board. The revised GCGLI 2013 did not recommended any preferable number of directors on the board of Malaysian listed financial institutions. BNM advised the number of executive directors on the board should be kept to the very minimum. In this regard, there should not be more than one executive director on the board of a licensed financial institution and preferably should be the CEO. However, under special circumstances, institutions may have up to a maximum of two executive directors. The board may invite other senior management officers to attend board meetings to provide inputs as and when necessary. According to Enobakhare (2010), board size is measured by the total number of directors that an organization has in its board.

The central task for a board is to work for the interest of all shareholders and ensure the continued existence of the firm. Based on the agency theory, the main consensus among finance academics is that the board of directors should be small in order to effectively manage the agency problem, and this is reflected in better financial performance (Ahmed, 2006). Linck, Netter and Yang (2008) explain that boards of small firms should include three members, the medium sized firms should include five members and large firms should include eight members. Smaller board of directors will take the responsibility for monitoring a company's operations more than a larger board of directors (Vaefas, 2000). It is reported that smaller boards can effectively monitor firm's activities than board in larger in size (Ramano and Guerrini, 2012; Byard, Li, and Weintrop, 2006; Haniffa and Hudaib, 2006). When the board is small, the responsibility of each member will be increased to monitor the firm's activity, and it will increase performance (Kim and Nofsinger, 2007). Minimum number of

directors with adequate knowledge and experience plays an important role to carry out the business effectively (Roseline, 1997).

If a board has too many members agency problems can arise because some directors may become free-riders, in which some directors not responsible in decision making and management (Boone et al. 2007). Mak and Yuanto (2003) while reporting about firms listed in Singapore and Malaysia, explain that the board with smallest board members is better informed thus can have better monitoring abilities. Management finds larger boards to be problematic when an organization needs to develop and challenge strategic matters (Joel and Dondjio, 2012).

The recommended number of directors present in any board should be seven or eight. Jensen (1993) states that the board which has seven or eight members will be effective in monitoring and decision making as more directors than this would cause trouble for the CEO to control them. This is also underlined by Florackis and Ozkan (2004) and Gabrielle (2003); according to them, when the number of board of directors gets beyond seven or eight it would be difficult for the CEO to control. This is because larger board has many members, some of who can tag along as free riders and thus agency problems can be generated. A larger board size has lesser capability to take control of the management which leads to separation of control and management and thus agency problems arise. When a board has many directors, it does not fulfill its proposed function but instead moves into a more symbolic role (Hermalin and Weisback, 2003).

Study of Goodstein et al (1994) indicated that the increased pool of expertise in the larger board has better ability to form suitable judgment. Belkhir (2005) reports that a larger board of directors in banks is positively associated with Return on assets. Larger boards having more knowledge and skill at their disposal will enhance performance (Willams, 2002). With regard to board size, there are lots of difference between financial and non-financial institutions. Adams and Mehran (2003) find that on an average bank holding company boards are larger than manufacturing firms. Large boards have the advantage of external links and associations. Very small boards do not have the spread of expert advice and more opinions as present in larger boards.

Larger boards have diversity in terms of skills, experience, nationality and gender (Dalton and Dalton, 2005).

Adams and Mehran, (2012) found board size and bank performance has a positive correlation by using data from four decades. Mohamed (2009) studied a sample consisting of 74 banks and observed that the relationship between board size and firm profitability in banking sector was positive. A research on listed banks in India conducted by Manas and Saravanan (2006) found that the influence of board size on bank performance has found to be absent. Larger complex companies' board sizes are positively associated with their performance but smaller and less complex companies' board sizes are negatively related with performance (Coles et al. 2008).

Some empirical studies in different countries report that there is no significant relationship between board size and performance (Zulkafli and Samad, 2007; Shelash Al Hawary, 2011). Bonn et al. (2004) found impact of board structure on firm performance between Japanese and Australian firms to be negatively correlated for Japanese firms but found no relationship for Australian counterparts. In an analysis of small and medium sized corporation, Bennedsen et al. (2004) reported that when the board size is less than six members, there is no performance effect found in corporations, but when the board size increases to seven members, it has negative effect. The research of Aminu et al. (2015) on the effects of board size and board composition on the performance of Nigerian banks, made use of financial statements from nine years of five banks as the sample and analysed using the multivariate regression analysis, signifies that an increase in board size would lead to a decrease in ROE and ROA. Result of Zabri et al. 2016 showed that board size has negative relationship with ROA and insignificant relationship to ROE when analyzing top 100 public listed companies in Malaysia. Roselina Shakir concluded that small board with more executive directors have positive association with firm performance in Malaysian companies. In a study by (Satirenjit, 2015), including 700 financial and non-financial firms in Malaysia, board size is found to be positively associated with firm performance.

Hilb (2005) stated that the size of board represents only number of members but effectiveness depends upon other factors such as directors' roles and social characteristics. Prior empirical studies reported conflicting results with regard to relationship between corporate performance and board size. To formally examine the relationship between board size and financial performance of licensed financial institutions in Malaysia, the following hypotheses are developed.

H5: There is an association between board size and return on asset (ROA).
H6: There is an association between board size and return on equity (ROE).

3.5 DEPENDENT VARIABLE - FINANCIAL PERFORMANCE

Companies are responsible to convey financial information to its stakeholders from time to time. The purpose of financial report is to give useful information for future decision making. This information will help stockholders and potential investors in deciding their investment on issued stock. Return on asset and Return on equity is some of the important information in the financial report. Creditors use this information to evaluate management performance and predict future profit. With the help of financial statements decision makers can judge the business activities in monetary terms.

Financial performance is the level of performance of a business over a specified period of time, expressed in terms of overall profits and losses during that time. Financial statement shows how the firm generate income with its assets. It is a measure of firms' activities over a specified period of time. Financial statement can be used to compare the business activities of one industry with other similar industries. This study considers financial institutions' financial performance as a dependent variable. Return on Asset (ROA) and Return on equity (ROE) are used as accounting measures of financial performance based on the work of many scholars (Pasiouras & Kosmidou, 2007; Ben Naceur & Goaied, 2003; Simpson & Kohers, 2002; Bauer, Koedijk & Otten, 2005; Derbali & Abdelkader, 2007). Some previous researches on corporate

governance used accounting based measures or market based measures to assess firm performance.

3.5.1 Return on Asset

ROA shows the amount of earnings generated from invested capital (Epps & Cereola, 2008). Return on Assets is the profitability ratio of annual net income (Earnings Before Interest and Taxes -EBIT) to total assets of a business during a financial year. ROA provides information to the investor about how the assets of the company are converted into net income (EBIT). An increasing trend of ROA indicates that the profitability of the firm is improving. Conversely, a decreasing trend means that profitability is deteriorating. With the use of assets and effective management the company generate the income is known as Return on Assets (ROA). It is computed as a ratio between net income (EBIT) and total assets (Burja, 2010).

Return on Asset = Net Income (EBIT) / Total Assets.

3.5.2 Return on Equity

Return on equity is the amount of net income (Profit After Tax excluding Preference Dividend - PAT-PD) returned as a percentage of shareholders' equity. Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested. ROE is expressed as a percentage and calculated as:

Return on Equity = Net Income (PAT-PD)/Shareholder's Equity

Net income is for the full fiscal year (before dividends paid to common stock holders but after dividends to preferred stock. Shareholder's equity does not include preferred shares, also known as "Return on net worth" (RONW).

3.6 CONTROL VARIABLES

The empirical model of this study also includes the size and age of financial institution as control variables. These control variables affect profitability of financial institutions and must be controlled in order to separate the corporate governance as a single variable. Prior studies have also used this variable as the control variable in their studies for examining the relationship between corporate governance variables (Xiao & Yuan, 2007; Hyytinen & Pajarinen, 2005; Leung & Horwitz, 2004).

3.6.1 Financial Institutions' Size

Asset size of the financial institutions is an appropriate control variable, because evidence shows that small and medium enterprises do not engage in corporate governance activities more than the larger companies (Graves & Waddock, 1994). Generally, larger the asset size of financial institutions, greater is the activity and the likelihood of voluntary disclosures (Brammer & Pavelin, 2006). Firms are normally interested to enhance public scrutiny and enhance reputation; these firms are voluntarily disclosing more information in their annual report which reflects its agency cost. Previous studies found firm size affect financial performance and is employed by numerous studies as a control variable (Burhop, 2009; J.Chen, Chen and He 2008; Abdelkarim and Alawneh, 2009; Mehdi, 2007; Ali, Akhtar and Ahmed, 2011). The study of Mabwe and Robert (2010) resulted that performance of bank was positively influenced by bank size. According to Athanasoglou et al. (2005), financial institutions' size is one of the internal factors that influence financial performance. Big firms can easily face the competition and can survive in business when compared with companies having less asset value; big firms have larger resources and are able to possess the opportunity to work in the field with less competition and can also increase returns (Bayyurt, 2007).

Compared with small firms, cost of product is less in big firms leading to more profit, big firms can provide concurrent product and services to the customer in large scale and various products may also leads to profitability (Aloy and Velnampy, 2014). Big firms can easily secure source, better rate of interest, better discount, thus firm size leads to better firms' performance (Siagian et al. 2013). In Malaysia, Haji (2014) found

that big firms can get more market power and better rate of interest. Findings of Ramasamy, (2005) suggest that firm size is negatively significant with performance in Malaysian palm oil industry. It is expected that financial institutions can also provide better service and profit maximization when the size of the institution is big. Based on Haji (2014) the size of financial institutions is measured by total asset value. Thus, size of financial institutions is used as control variable in this study.

3.6.2 Financial Institutions' Age

Financial institutions age is selected as one of the control variable in this study in the analysis of financial performance. Studies by Zakaria et al. (2014) and Haslindar (2011), uses age as a control variable to minimize specification errors. Age is defined as the number of years since the institution was established. Older firms possess some competencies and skills which new firms cannot develop in its initial stage (Ramasamy. B, 2005). Old firm have higher firm value so that they had better firm performance in Malaysia (Amran and Ahmand, 2010). Older firms can enjoy superior performance because of more experience (Kumar, 2003). Younger firm have less capability to obtain new technological sources which shows in its performance (Bernardo and Chowdhry, 2002). Better governance and knowledge can be obtained by more experience (Galende & De La Fuente, 2008). Jiangyong et al. (2009) found negative and significant association between age and performance.

3.7 SUMMARY OF THE CHAPTER

This chapter has presented elaborate information and empirical evidence on agency theory and its relevance to corporate governance. Agency theory is used as a theoretical framework to develop hypothesis and to analyse the relationship between audit committee, board composition and board size on ROA and ROE. Various studies and research on agency theory and corporate governance are presented, and suitable variables for the study are identified and hypotheses are constructed. These literatures provide the support to proceed the study with the selected variables.

CHAPTER 4

RESEARCH METHODOLOGY

4.1 INTRODUCTION

The design of a suitable methodology, sampling, and method of data collection and selection for the proper analytical tools is important for a meaningful and useful analysis in any research undertakings. This chapter attempts to describe methodology, elucidate the research method, present the study population, illustrate the method, types and sources of sample size and explain the data collection, lay out the period of study, geographical coverage, variables and measurement of variables, demonstrate research framework and data analysis.

4.2 RESEARCH METHOD

The study seeks to determine the impact of corporate governance on the financial performance of financial institutions in Malaysia. This study also identifies whether the financial institutions comply with Bank Negara Malaysia's Guidelines on Corporate Governance for Licensed Institutions (GCGLI 2013) issued by Securities Commissions, Malaysia.

This study collects the data related to selected variables (audit committee, board size and board composition) directly from annual reports of the selected financial institutions. Every entity have better communication with their shareholders and stakeholders through annual reports which reduces information asymmetry and reduce opportunistic behavior (Amir Ranjbar, 2009). Hence, the present study is based on secondary data as the secondary data is a way of gaining knowledge by means of direct observation from evidences. (Siddiqui, 2015; Sylvie, Tania and Cameron, 2010; Amir Ranjbar, 2009) conducted research based exclusively on secondary data, and these studies collected the data on study variables from related annual reports.

Content analysis is a research technique applied to make reproducibility and valid inferences by interpreting and coding textual material. From the current study, the quantitative information was observed from the annual reports of financial institutions about the variables as followed by Faizah Darus et al. (2015). In simple terms, content analysis is retrieving meaningful information from documents (Tipaldo G. 2014). The present study is eliciting data from the audited annual reports of the financial institutions.

Further, the study applies cross sectional data was adopted to sort out the existence and magnitude of casual effects of one or more independent variables upon a dependent variable at a given period of time.

4.3 STUDY POPULATION

Malaysian financial system is classified into two major sectors; financial institutions and financial markets. The financial institutions are further classified into three parts that are licensed banking institutions, licensed insurance companies and licensed takaful operators. All the licensed financial institutions are considered as population for the present study. There are 59 licensed Banking institutions, 40 licensed insurance companies and 16 licensed takaful operators performing their functions in Malaysia in the name of licensed financial institutions. The present study considers the total population of the study to be 115. The total population of the study is presented in the Table 4.1.

Table 4.1 Population of the study (Licensed Financial Institutions in Malaysia)

SN	Classification of Licensed Financial Institution	Name of the Financial institution	Total Number of financial institutions	Percentage of financial Institution (%)
1	Licensed Banking Institutions	Commercial Banks	27	23.48
		Islamic Banks	16	13.91
		International Islamic Banks	3	2.61
		Investment Banks	11	9.57
		Other Financial Institutions	2	1.73
		Total	**59**	**51.30**
2	Licensed Insurance Companies	Life and General Business	4	3.47
		Life Business only	10	8.70
		General Business only	19	16.52
		Life and General Reinsurance Business	1	0.87
		Life Reinsurance Business	1	0.87
		General Reinsurance Business	5	4.34
		Total	**40**	**34.78**
3	Licensed Takaful operators	Takaful operators for family Takaful Business	3	2.60
		Takaful operators for Family and General Takaful Business	9	7.82
		Retakaful operators for General Retakaful Business	1	0.87
		Retakaful Operators for Family and General Retakaful Business	3	2.60
		International Takaful Operators	Nil	-
		Total	**16**	**13.91**
		Grand Total	**115**	**100.00**

Source: Compiled from Bank Negara Malaysia Website [www.bnm.gov.my]

4.4 SAMPLE SIZE AND METHOD

This study intends to analyze the financial institutions listed under main board of Bursa Malaysia. The secondary data required for this study can be obtained from annual reports of financial institutions for the year 2014, which is the up-to-date data when the study was begun. When analyzing the corporate governance and financial performance in Malaysian companies, Amir Ranjbar (2009) used secondary data obtained from annual reports. All the listed financial institutions' data derived from

annual report is available in website of Bank Negara Malaysia. These annual reports are easily accessible and are credible due to their high degree of accuracy and reliability because these annual reports were already audited. The basic requirement of the data collection is the availability of annual report for the year 2014 for the licensed financial institutions. 2014 is the contemporaneous data for this study. When the researcher started collecting data in the year 2015, the only available annual report after the implementation of GCGLI 2013 was for the year 2014. To find the sample required for the study, this study used following table by Reisman 2000, A Field guide to outcomes based program evaluation.

Table 4.2 Population and Sample Sizes

Population Size (N)	**±5%**
100	**80**
250	152
500	217
Adapted from Reisman, 2000, A Field-Guide to Outcomes-Based Program Evaluation	

The annual reports of the financial institutions are obtained based on the availability in the BNM website and also all the required data are thus obtained. 83 out of 115 (72%) financial institutions are selected on convenience sampling basis. This design was followed with a view to cover all the financial institutions listed in Bursa Malaysia. The financial institutions are classified into three sectors such as Licensed Banking Institutions, Licensed Insurance Companies and Licensed Takaful operators. The details of sample selection are presented in the Table 4.2.

Table 4.3 Sample selection of financial institutions in Malaysia

SN	Classification of Licensed Financial Institution	Name of the Financial institution	Total Number of financial institutions	Sample selection of financial institutions (Nos.)	Sample selection of financial institutions (%)
1	Licensed Banking Institutions	Commercial Banks	27	22	81%
		Islamic Banks	16	14	87.5%
		International Islamic Banks	3	2	66.67%
		Investment Banks	11	7	63.63%
		Other Financial Institutions	2	0	0
		Total	**59**	**45**	**76.27%**
2	Licensed Insurance Companies	Life and General Business	4	2	50%
		Life Business only	10	9	90%
		General Business only	19	15	78.94%
		Life and General Reinsurance Business	1	-	
		Life Reinsurance Business	1	-	
		General Reinsurance Business	5	2	40%
		Total	**40**	**28**	**70%**
3	Licensed Takaful operators	Takaful operators for family Takaful Business	3	3	100%
		Takaful operators for Family and General Takaful Business	9	5	55%
		Retakaful operators for General Retakaful Business	1	1	100%
		Retakaful Operators for Family and General Retakaful Business	3	1	33%
		International Takaful Operators	Nil	0	0
		Total	**16**	**10**	**62.5%**
		Grand Total	**115**	**83**	**72.17%**

4.5 TYPES, SOURCES AND DATA COLLECTION

Audited annual report is the primary source of data collection in the study. Annual report is a key corporate communication tool (Amran et al. 2013). Various corporate governance research in Malaysia have used annual report as the fundamental source of data (Fekri 2016; Joel and Dondjio (2012); Esa and Ghazali 2012). The secondary

data is derived from audited annual reports of the listed financial institutions in Malaysia to analyse the relationship between dependent (predicted) and independent (predictor) variables. This study adopted a content analysis approach to obtain secondary data for the financial year 2014 derived from annual reports published by Bank Negara Malaysia's website and websites of the respective financial institutions. Researcher used a check list to enter the data consisting of audit committee, board composition, board size, financial institutions' size, financial institutions' age, return on asset and return on equity. The study collected the details of 3 independent variables from 83 financial institutions, therefore, there are 249 observations. In the case of dependent variables namely ROA and ROE, data were collected from selected 83 financial institutions and it contains 166 observations. Further the study collected data for 2 control variables from 83 financial institutions, therefore it is 166 observations. In total, the study observed 581 aspects (observations) from the 83 financial institutions for the period of 2014.

4.6 PERIOD OF STUDY

Prudential Financial Policy Department of BNM issued a guideline for licensed institutions in the year 2013. These guidelines were passed and came into force with immediate effect on 19 June 2013 (Bank Negara Malaysia 2013). The present study seeks to enquire about the licensed financial institutions' performance after implementing these guidelines (GCGLI 2013) as well as to know the compliance of guidelines by the licensed financial institutions. This study seeks to analyse the contemporary effect of GCGLI 2013 for financial institutions' financial performance for the year 2014 after implementing GCGLI 2013.

Some studies have used one year data for their research such as study by Huang, (2010) which reveals board size , independent directors and family owned share having a positive impact on bank performance. Ponnu & Karthigeyan, (2010) did one year study of 2006 to find no positive evidences on corporate governance and outside directors. Another study in Egypt by Shahwan, (2015) regarding corporate governance on financial performance, found that firms' corporate characteristic could influence firm financial performance. Mostafa and Sawsan (2013) collected

data from annual reports of 95 corporations from different sectors for the year 2008 derived from Emirates Security and Commodity Market Authority for the analysis.

4.7 VARIABLES AND MEASUREMENT OF VARIABLES

The basic aim of the study is to identify the impact of corporate governance on the financial performance of licensed financial institutions in Malaysia, in which the corporate governance is treated as the independent variable. In Malaysia, widely mentioned three independent variables are audit committee, board composition and board size (M.S.W. Leong, 2015; Kallamu, 2015; Al.Mamun, 2014; Zubaidah, 2009; Ponnu, C.H., 2008; Amir Ranjbar, 2009). The present study has also selected these three variables as independent variables for the study.

The financial performance of financial institutions is the dependent variable of the study. Several studies in accounting as well as related areas (Akshita and Chandan, 2016; S.N.Shukeri, et al. 2012; Pathan et al., 2008; Ponnu, C.H., 2008) considers dependent variables to be return on assets and return on equity. The current study also depends on similar literature and selected these two variables for analysis as dependent variables.

The empirical model of this study also includes two control variables which are size and age of the financial institutions. These two control variables are selected because these variables may affect firms' performance. Most studies used these variables as the control variable in their study examining the relationship between corporate governance variables (Xiao and Yuan, 2007; Hyytinen and Pajarinen, 2005; Leung and Horwitz, 2004).

The independent and dependent variables are measured for the purpose of analysis in this study. The methods of measurement of the variables are given in detail. The audit committee refers to number of independent non-executive directors in the audit committee; the audit committee is taken for analysis in the form of numbers. The board

composition refers to the number of independent non-executive directors in the board relative to the total number of directors. The board size refers to the total number of directors serving on the board; this variable is taken in numbers for analysis. The financial performance is measured by using return on asset and return on equity (dependent variables) which are common accounting measures in the empirical study. To probe further, the name of the variables, acronyms of the variables and measurement of the variables are presented in the Table 4.4.

Table 4.4 Study variables, Acronyms, and Measurement of variables

SN	Nature of the variable	Name of the variable	Acronym	Measurement of variable
1	Independent variables	Audit Committee	AC	Number of independent non-executive directors serving in audit committee
		Board Composition	BC	The number of independent non-executive directors on the board relative to the total number of directors
		Board Size	BS	Total number of directors is serving on the board.
2	Dependent Variables	Return on Assets	ROA	Net income (EBIT) / Total assets
		Return on Equity	ROE	Net Income (PAT-PD) / Shareholder's equity
3	Control Variables	Financial institutions size	FIS	Natural log of total assets of the FIs
		Financial institutions age	FIA	Number of years in service

4.8 RESEARCH FRAMEWORK AND DATA ANALYSIS

This study uses cross sectional data to predict the dependent variables' value through the independent variables. Cross sectional data is a type of observational study that involves the analysis of data collected from a population at one specific point of time, in this study, the year 2014. This study has three independent variables; in order to find the impact of these independent variables to two proxies of financial performance variable, the author used multiple regression analysis. This study has two models to find the impact of corporate governance variables with ROA and ROE. Previous

literatures (Guo, Kga, 2012; Shukeri, et al. 2012; Dogan et al., 2013) used multiple regression analysis in finding CG and firm performance of listed firms.

The general plan of the analysis ranges from descriptive statistics to multiple regression models. The study applied descriptive statistics to describe the basic features of the data used in the study. Mann, Prem (1995), explained the term descriptive statics to quantitatively describe or summarise the features of a collection of information. Further, the descriptive statistics are used to describe the present quantitative descriptions in a manageable form. Descriptive statistics helps to simplify the large amounts of data in a sensible way.

Descriptive statistics is explained about the basic features of the independent and dependent variables. Further it explains simple summaries about data and basis information about variables in data set. Descriptive statistics provide summarized details about large sized data. It highlights range among variables. Descriptive statistics is used to summarize the raw data in a understandable meaningful way by reducing raw data to manageable proportion.

The first part of the analysis is descriptive statistics which is used to check whether the data are approximately normally distributed. Descriptive statistics includes mean, minimum, maximum and standard deviation for all of the variables. The independent variables and dependent variables data for the year 2014 has been presented in descriptive form. The normality test has been conducted in the study; in general normality test is used to determine the collected data set is well-modeled by a normal distribution. The normality tests are used to determine if a data set taken from total population is well modeled and approximately normally distributed. This study applied normality test, which includes skewness and kurtosis. This study used Pearson's correlation to find any multicollinearity among variables used in the study.

In order to check the cross-sectional association between independent variable namely audit committee, board composition and board size with dependent variable ROA, the multiple regression model is:

Model: 1

$$\mathbf{ROA}\gamma_1 = \beta_0 + \beta_1 AC_{x1} + \beta_2 BC_{x2} + \beta_3 BS_{x3} + \varepsilon_x \quad \text{.......Eq 1}$$

Model: 2

$$\mathbf{ROA}\gamma_2 = \beta_0 + \beta_1 AC_{x1} + \beta_2 BC_{x2} + \beta_3 BS_{x3} + \beta_4 FIS_{x4} + \beta_5 FIA_{x5} + \varepsilon_x \quad \text{.......Eq 2}$$

In order to check the cross-sectional association between independent variable, namely audit committee, board composition and board size with dependent variable ROE, the multiple regression model is:

Model:3

$$\mathbf{ROE}\gamma_3 = \beta_0 + \beta_1 AC_{x1} + \beta_2 BC_{x2} + \beta_3 BS_{x3} + \varepsilon_x \quad \text{......Eq 3}$$

Model: 4

$$\mathbf{ROE}\gamma_4 = \beta_0 + \beta_1 AC_{x1} + \beta_2 BC_{x2} + \beta_3 BS_{x3} + \beta_4 FIS_{x4} + \beta_5 FIA_{x5} + \varepsilon_x \quad \text{......Eq 4}$$

Where

ROAγ_1= Dependent variable: Financial Performance (Return on asset)

ROEγ_3= Dependent variable: Financial Performance (Return on equity)

β_o = Coefficient

x1 = Audit Committee

x2 = Board Composition

x3 = Board Size

x4 = Financial Institutions Size

x5 = Financial Institutions Age

ε = Error term

Error term accounts for other possible factors that could influence Return on Asset and Return on Equity which are not captured in the model.

The compliance of guidelines related to licensed financial institutions is discussed in the analysis. This is analyzed through simple percentage model.

The audit committee principle is measured by dividing the number of independent non- executive directors in audit committee of each licensed financial institution, by the total number of directors in the audit committee of the respective financial institution. The result is represented in the form of percentage. According to the guidelines (GCGLI 2013), majority of the directors from the audit committee are independent non- executive directors. The term majority is considered as more than 50 per cent. If the calculated result (number of non-executive directors in audit committee over total number of directors in the audit committee) exceeds 50%, then the financial institution is considered as complied (majority) therefore it is valued 1, otherwise not complied 0. In such a way, all the 83 licensed financial institutions are calculated and identified the compliance.

The board composition is measured by dividing the number of independent non-executive directors in the board of each licensed financial institution, by total number of directors in the board. According to guidelines (GCGLI 2013), licensed financial institutions are required to ensure at least one third of their board members are independent directors. The term one third is considered as more than 33.33 per cent. If the calculated result (number of non-executive directors in board to be over total number of directors in the board) exceeds 33.33% then the financial institution is considered as complied (one third) and therefore it is valued 1, otherwise not complied 0. In such way, all the 83 licensed financial institutions are calculated and identified the compliance related to board size.

The board size is measured through the number of independent non-executive directors in the financial institution. It is calculated based on numbers. According to guidelines (GCGLI 2013), there is no specified number of independent non- executive of directors for licensed financial institutions. But research in this area argues that a board should not be too big nor too small. A well-accepted study in this area, (Fitriya & Stuart 2012) has identified the ideal size to be eight. The compliance analysis made in the assumption of nominal board size is 8. Accordingly, the licensed financial institutions are analyzed one by one and number of independent non- executive of directors in the financial institution is counted. If the number is eight or above, it is

treated as complied and given the value 1, otherwise considered not complied and value is given to be 0.

4.9 RESEARCH HYPOTHESES

Number of studies in the developed and developing countries on the impact of CG and financial performance are largely focused on non-financial institutions. Even though there are some studies on financial institutions, they are focused on banks only. In Malaysia, after the implementation of GCGLI 2013, no studies have been carried on whole financial institutions which includes banking institutions, insurance companies and takaful operators, that is the research gap. So, in order to check the impact of GCGLI 2013 on financial institutions financial performance and to investigate whether the financial institutions complied with GCGLI 2013, this study develops following hypotheses:

Objectives 1: To determine the impact of corporate governance on return on assets of financial institutions in Malaysia.

1.1 To determine the impact of Audit committee on Return on Assets
1.2 To determine the impact of Board composition on Return on Assets
1.3 To determine the impact of Board size on Return on Assets

H1: There is an association between independent non-executive directors in audit committee and Return on Asset (ROA).
H3: There is an association between independent non-executive directors in board and Return on Asset (ROA).
H5: There is an association between board size and Return on Asset (ROA).

Objectives 2: To determine the impact of corporate governance on Return on Equity of financial institutions in Malaysia.

2.1 To determine the impact of Audit committee on Return on Equity
2.2 To determine the impact of Board composition on Return on Equity
2.3 To determine the impact of Board size on Return on Equity

H2: There is an association between independent non-executive directors in audit committee and Return on Equity (ROE).

H4: There is an association between independent non-executive directors in board and Return on Equity (ROE).

H6: There is an association between board size and Return on Equity (ROE).

4.10 SUMMARY

This chapter intended to present detailed information about methodology used in the study. The study intends to use cross sectional data collected from population at one specific point of time. Cross sectional data provides information on the characteristics of statistical relationship between individual units of study at a specified time. The variables used for the study and measurement of variables are also explained in this chapter. The main tool of analysis in this study is multiple linear regression model. Next chapter presents the results and discussion of the study.

CHAPTER 5

RESULT AND DISCUSSION

5.1 INTRODUCTION

This chapter reports the results of quantitative analyses of the impact of corporate governance on the financial performance of financial institutions in Malaysia. The test results of various analyses on the impact of corporate governance on the financial performance of financial institutions in Malaysia is presented in detail. Section 2 of the chapter is about Compliance of corporate governance guidelines. Section 3 provides results of whether financial Institutions in Malaysia comply with GCGLI2013. Section 4 provides the result and discussion of the descriptive analysis and section 5 provides assumptions of multiple regression analysis. Part 6 of the chapter is about multiple regression analysis for ROA and part 7 contains result of multiple regression analysis for ROE. Model summary and ANOVA test results follow.

5.2 Compliance of Corporate Governance Guidelines

The basic intention of BNMs guidelines is to promote the adoption of effective and high standards of corporate governance practices by licensed institutions. Various literature have discussed different guidelines and compliance of different organizations, it includes few empirical research results also.

A study conducted by Dahya and McConnell (2007) analyzed Cadbury codes and UK listed companies. The study pointed out that the companies are complied with the guidelines accurately, the study also focused on number of non-executive directors in the board composition. It concludes that three independent non-executive directors in the board shows a significant improvement in corporate performance, as measured through ROA. Another study (Effiezal A. Abdul Wahab, Janice How and Peter Verhoeven 2001) was conducted on the compliance of Malaysian code of corporate governance and institutional investors and stock performance. This study analyses 440 firms from 1999 to 2002 and finds that corporate governance reform in Malaysia has been successful, with a significant improvement in governance practices.

Among various literatures available for study on compliance of CG guidelines, Bawaneh (2011), Abu Risheh and Al-Sa'eed (2012) supported that banking sector of Jordan has complied with the OECD Principles of corporate governance. Through a survey on annual reports of 556 public listed companies in Bursa Malaysia, formerly known as Kuala Lumpur Stock Exchange, Mohamad Ibrahim et al. (2004) found the level of corporate compliance to the code of best practice in these firms is very high. Al-Saeed (2013) found compliance of Jordanian banks from the view point of audit committee members. The finding of Al-Baidhani (2014) mentions that the compliance of audit committee plays a significant role in organization's control and direction. Previous studies (Bedard et al., 2004; McDaniel et al., 2012) also argued that compliance of audit committee as mentioned in their annual report improves audit committee performance.

5.3 FINANCIAL INSTITUTIONS IN MALAYSIA COMPLY WITH THE BNM's GUIDELINES GCGLI 2013

Sub-objectives of the study are to identify whether the financial institutions in Malaysia comply with the BNM's revised guidelines on corporate governance or not. The BNM provided the list of licensed financial institutions in their official website. According to BNM the licensed financial institutions are broadly classified into three categories: licensed banking institutions, licensed insurance companies and licensed takaful operators. As per the BNMs statistical information, at present there are 59 licensed banking institutions, 40 licensed insurance companies and 16 licensed takaful operators are in Malaysia. As per the sampling technique, the study selected 66% of banking institutions and the sample selection of insurance and takaful operators are 70% and 30% respectively. The overall selection of licensed financial institutions of sample for the study is 67 percentage.

5.3.1 Financial institutions compliance - Audit committee related principle

Section 2.8 of principle 1 in BNMs revised guideline specified the audit committee, it is one of the principle that must complied by the licensed financial institutions in

Malaysia. The principle specifically mentioned that the majority of the independent non-executive directors must be in the audit committee. The compliance of audit committee principle is calculated by the number of independent non-executive directors of each licensed financial institution, which is divided by total number of directors of the financial institution. The result represented in the form of percentage. If the result exceeds 50%, then it is considered as complied (majority), therefore it is valued 1 otherwise not complied and valued 0. Similar valuation is done for all the 115 licensed financial institutions. For example, Affin Bank Berhad's total number of independent non-executive directors is 3 is divided by the total number of directors which is also 3, therefore the result is 100%. In this case, this bank percentage exceeds 50, therefore this institution is complying the principle. The institution wise compliance information is presented in Table 5.1.

Table 5.1 Licensed Financial institutions' compliance of Bank Negara Malaysia's revised guidelines (GCGLI) - Audit committee

Licensed Financial institution	Name of the Financial institution	No. of institution Complied (Nos.)	No. of institution Complied (%)	No. of institution not complied (Nos.)	No. of institution not complied (%)	Total No of institutions (Nos.)
Banking institutions	Commercial Banks	17	77	5	23	22
	Islamic Banks	11	79	3	21	14
	International Islamic Banks	2	100	0	0	2
	Investment Banks	7	100	0	0	7
	Other financial institutions	-	-	-		-
Total		37	82	8	18	45
Insurance companies	Life and general business	2	100	0	0	2
	Life business only	9	100	0	0	9
	General business only	15	100	0	0	15
	Life and general reinsurance business	-	-	-	-	-
	Life reinsurance business	-	-	-	-	-
	General reinsurance business	2	100	0	0	2
Total		28	100	0	0	28
Takaful operators	Takaful operators for family Takaful Business	3	100	0	0	3
	Takaful operators for Family and General Takaful Business	5	100	0	0	5
	Retakaful operators for General Retakaful Business	1	100	0	0	1

	Retakaful Operators for Family and General Retakaful Business	1	100	0	0	1
	International Takaful Operators	-	-	-	-	-
Total		10	100	0	0	10

Source: Computed for this study from the Annual reports of licensed financial institutions in Malaysia

The analysis shows that all the banking institutions are complied with the audit committee principle. More than 50% of independent non-executive directors are serving in the audit committee, except for 5 commercial banks and 3 Islamic banks. From these 5 commercial banks 4 of them have exactly 50% of independent non-executive directors in the audit committee. Another one bank secured 33% of independent non-executive director in the audit committee. Further analysis reveals that among the five non-complying commercial banks, four of them are foreign owned licensed financial institutions.

In the case of Islamic banks, among the 14 banks, 3 (21%) of them did not comply with the principle of audit committee. From these, 2 of them have 50% of independent non-executive directors in the audit committee, the remaining one bank has 40% of the independent non-executive directors in the audit committee. International Islamic banks and investment banks compiled with the principle in 100%. Therefore, the analysis clearly shows that majority of the banking institutions compiled with audit committee principle. The hypothesis is accepted, stated that the licensed banking institutions in Malaysia are complied with Bank Negara Malaysia’s guidelines viz. GCGLI 2013 regarding audit committee.

This analysis shows that all the insurance companies complied with the principle regarding audit committee. From the total 28 insurance companies 13 of them have 100% independent non-executive directors and the remaining companies have more

than 50% of independent non-executive directors. All the insurance companies are complied with the principle, therefore the hypothesis is accepted that the licensed insurance companies in Malaysia have complied with Bank Negara Malaysia's guidelines viz. GCGLI 2013 regarding audit committee.

There are 10 licensed takaful operators in Malaysia, all the operators are compiled with the principle regarding the audit committee. Three takaful operators have 100% of independent non-executive directors and the remaining seven takaful operators have more than 60% of independent non-executive directors and fulfil the guidelines' requirement. Therefore, the hypothesis is accepted that the licensed takaful operators in Malaysia have complied with Bank Negara Malaysia's revised guidelines viz. GCGLI 2013 regarding audit committee.

5.3.2 Financial institutions compliance - Board composition related principle

Principle 2 of BNMs revised guideline specifies the information about board composition, it is one of the important principles of guideline for the licensed financial institutions in Malaysia. According to the principle, the licensed financial institutions are required to ensure that at least one third of their board members are independent directors. Here the study calculates the number of independent directors in the board of each individual financial institution. The identified number of independent directors are divided by the total number of directors. The result is converted into percentage by multiplying it by hundred. If the result is 33.33 or above it is considered 1, if the result is lower than 33.33 it denotes 0. The same rule is applied for all financial institutions selected for the study. The financial institution scored 1 is considered to be complied with the principle, otherwise treated as not in compliance. The institution wise compliance about board composition information is presented in table 5.2

Table 5.2 Licensed Financial institutions' compliance of Bank Negara Malaysia's revised guidelines (GCGLI) - Board composition

Licensed Financial institution	Name of the Financial institution	No. of institution Complied (Nos.)	No. of institution Complied (%)	No. of institution not complied (Nos.)	No. of institution not complied (%)	Total No of institutions (Nos.)
Banking institutions	Commercial Banks	20	91	2	9	22
	Islamic Banks	13	93	1	7	14
	International Islamic Banks	2	100	0	0	2
	Investment Banks	7	100	0	0	7
	Other financial institutions	-	-	-		-
	Total	42	93	3	7	45
Insurance companies	Life and general business	2	100	0	0	2
	Life business only	9	100	0	0	9
	General business only	14	93	1	7	15
	Life and general reinsurance business	-	-	-	-	-
	Life reinsurance business	-	-	-	-	-
	General reinsurance business	2	100	0	0	2
	Total	27	96	1	4	28
Takaful operators	Takaful operators for family Takaful Business	3	100	0	0	3
	Takaful operators for Family and General Takaful Business	5	100	0	0	5
	Retakaful operators for General Retakaful Business	1	100	0	0	1

	Retakaful Operators for Family and General Retakaful Business	1	100	0	0	1
	International Takaful Operators	-	-	-	-	-
Total		10	100	0(0%)	0	10

Source: Computed for the study from the Annual reports of licensed financial institutions in Malaysia

The result of the analysis show that the banking institutions' overall compliance is appropriate. Among the 45 banking institutions, 42 (93%) of the institutions compiled with BNMs guidelines. In the case of commercial banks, 2 of them (9%) did not comply with guidelines, their board composition is 20% which means these two commercial banks' proportion of independent non-executive directors to the total board of directors is less than the guidelines i.e. one third. Islamic banks and international Islamic banks are also 100% compiled with the principles. All the six investment banks are compiled with the principles, the minimum calculated board composition percentage is 40. Therefore, it is clear that the constructed hypothesis is accepted, i.e. the licensed banking institutions in Malaysia have complied with Bank Negara Malaysia's guidelines viz. GCGLI 2013 regarding board composition.

This analysis shows that the insurance companies overall percentage of compliance is 96%. Among the 28 insurance companies, almost all the companies (except one company) were compiled with the BNMs guidelines on corporate governance for licensed institutions. Life and general business, life business only and general reinsurance business compiled 100%. The insurance company deals with 'general business only' achieved 93% of compliance. Therefore, the pre-determined hypothesis is accepted. The licensed insurance companies in Malaysia have complied with Bank Negara Malaysia's guidelines viz. GCGLI 2013 regarding board composition. It is inferred from the table 5.3 all the takaful operators compiled with the BNMs guidelines. The total 10 takaful operators' board composition is more than one third of the board. Therefore, the set hypothesis is accepted i.e. the licensed takaful operators in Malaysia have complied with Bank Negara Malaysia's revised guidelines viz. GCGLI 2013 regarding board composition.

5.3.3 Financial institutions compliance - Board size related principle

According to Guidelines on corporate governance for licensed institutions, no specified number of the board members are recommended. But literature studies in this regard argues that a board should not be too big nor too small. Most studies conclude that the ideal size is seven. Joel & Dandjio, (2012) suggest that to ensure effectiveness the size of the board should be less than 8. The compliance analysis is made on the assumption of nominal board size to be 7. The licensed financial institutions are analyzed one by one and number of directors in the institution are noted. If the number is seven and above it is considered to be in compliance and given value 1, otherwise considered not complied and given value 0. The board size related principle and financial institutions compliance is presented in the table 5.3.

Table 5.3 Licensed Financial institutions' compliance of Bank Negara Malaysia's revised guidelines (GCGLI) - Board size

Licensed Financial institution	Name of the Financial institution	No. of institution Complied (Nos.)	No. of institution Complied (%)	No. of institution not complied (Nos.)	No. of institution not complied (%)	Total No of institutions (Nos.)
Banking institutions	Commercial Banks	13	59	9	41	22
	Islamic Banks	11	79	3	21	14
	International Islamic Banks	1	50	1	50	2
	Investment Banks	6	86	1	14	7
	Other financial institutions	-	-	-	-	-
	Total	**31**	**68**	**14**	**32**	**45**
Insurance companies	Life and general business	2	100	0	0	2
	Life business only	5	55	4	45	9
	General business only	10	67	5	33	15
	Life and general reinsurance business	-	-	-	-	-

	Life reinsurance business	-	-	-	-	-
	General reinsurance business	1(50%)	50	1(50%)	50	2
	Total	**18**	**64**	**10**	**36**	**28**
Takaful operators	Takaful operators for family Takaful Business	2	67	1	33	3
	Takaful operators for Family and General Takaful Business	4	80	1	20	5
	Retakaful operators for General Retakaful Business	1	100	0	0	1
	Retakaful Operators for Family and General Retakaful Business	1	100	0	0	1
	International Takaful Operators	-	-	-	-	-
	Total	**8**	**80**	**2**	**20**	**10**

Source: Computed for the study from the Annual reports of licensed financial institutions in Malaysia

It is inferred from the Table 5.14 that the overall compliance rate of banking institutions is 68%. The 59% commercial banks compiled and the remaining 41% did not comply. The compliance percentage of Islamic bank and investment bank are 78% and 86% respectively. International Islamic bank compliance and non-compliance are same at 50% each. In the point of overall percentage, the banking institutions complied with the BNMs guidelines regarding the board size. Therefore, the preset hypothesis is accepted i.e., the licensed banking institutions in Malaysia have complied with Bank Negara Malaysia's revised guidelines viz. GCGLI 2013 regarding board size.

The result of the analysis shows that the overall percentage of compliance of licensed insurance companies is 64% and the non-compliance is 36%. The insurance company deals with 'life business only' almost equal the number of companies that did not

comply the BNMs guidelines. The table shows that 55% of life business companies complied and 45% did not comply. And the general reinsurance business company has 50% of compliance. Therefore, the analysis can conclude that the licensed insurance companies complied with the principles. So, the hypothesis is accepted. It is accepted that the licensed insurance companies in Malaysia have complied with Bank Negara Malaysia's revised guidelines viz. GCGLI 2013 regarding board size.

Further, the study reveals that 80% of the licensed takaful operators complied with the BNMs guidelines. All the 'Retakaful operators for General Retakaful Business' and 'Retakaful Operators for Family and General Retakaful Business' have compiled the principles of BNM. The result of the analysis shows that the hypothesis can be accepted i.e., the licensed takaful operators in Malaysia have complied with Bank Negara Malaysia's revised guidelines viz. GCGLI 2013 regarding board size.

5.4 DESCRIPTIVE STATISTICS

Descriptive statistics helps us to describe the relevant aspect of phenomena under consideration and provide detailed information about each relevant variable. The summary of the descriptive statistics for study in financial institutions is reported in Table 5.4. It shows the distribution of the corporate governance independent variables (audit committee, board composition and board size), Return on Asset and Return on Equity as dependent variable and also two control variables (financial institutions size and financial institutions age).

5.4.1 Financial Performance

ROA is measured by the net income **(EBIT)** to total asset ratio for 83 financial institutions listed in Bursa Malaysia. Table 5.4 shows the mean value of Return on Asset to be 1.96% ranging from -6.40 to 11.10 percentage in the year 2014. ROE is measured by the net income **(PAT-PD)** to shareholders equity ratio. ROE is as high as 9.20 percent with a mean value of -0.58. ROA and ROE displays wide variation among financial institutions. This may be due to differences in capital, management and operational choices, staffing, security investment and lending policies.

5.4.2 Corporate governance variables

Table 5.4 states that the mean value of audit committee (AC) to be 77% ranging from 33% to 100% indicating that the audit committee is mostly composed by independent non-executive members. This table is in compliance with GCGLI 2013 since it requires that the majority of the members in audit committee should be independent non-executive directors.

The value of Board Composition (BC) in licensed financial institutions ranges from 20% to 92%. The mean value for board composition is 52% which shows that there is an equal number of independent non-executive directors in the board. It compliances with guidelines on corporate governance for licensed institutions, which requires that at least one-third of the board members are independent directors. GCGLI 2013 advocating higher proportion of independent non-executive directors could mitigate any possible conflict of interest between the policy making process and the day to day management of the licensed institution. Table 5.4 shows the mean value of board composition (52%) is complying with GCGLI 2013.

The mean value of board size (BS) is 7.92 with the range between 4 to 15 which satisfies the requirement that the number of members in the board should be less than eight. Some previous studies (Joel & Dandjio, 2012; Hermalin & Weisback, 2003; Florackis & Ozkan, 2004; Gabrielle 2003) also supports the number of board members to be less than eight.

5.4.3 Control variables

Financial institutions' size is considered to be the one of the control variable of this study. The mean value for this variable is 9.88 ranging from 7.17 to 13.31. Mean value of another control variable s' age ranges from 0 to 5 with the mean of 2.96. Financial institutions' size is measured by total asset; practically asset and age of financial institutions are not in equal range.

Table 5.4: Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Dev.
Return on Assets	83	-6.40	11.10	1.96	2.469
Return on Equity	83	-.14	9.20	0.58	1.454
Audit Committee	83	33	100	77.77	18.533
Board Composition	83	20	92	51.79	15.454
Board Size	83	4	15	7.92	2.355
Financial Institution Size	83	7	13	9.88	1.093
Financial Institution Age	83	0	5	2.90	1.208

5.5 ASSUMPTIONS OF MULTIPLE LINEAR REGRESSION ANALYSIS

In order to discover the impact of corporate governance variables with financial performance, this study uses multiple regression analysis. Before running multiple linear regression analysis, the data has been checked for linearity, normality, multicollinearity and homoscedasticity.

5.5.1 Linearity

The first assumption of multiple regression analysis is linearity between the independent and dependent variables. In linear relationship, any given change in independent variable will always produce a corresponding change in the dependent variable. Test of linearity can be tested with scatter plots. Figures 5.1 shows almost there is a linear trend among independent, dependent and control variables.

According to Figure 5.1 clearly indicates the relationship between variables. In table 5.1 shows the linearity between ROA and other variables. It is clear that BS and BC have perfect relationship. In addition, it indicates that the FIS and BS are highly fluctuating. In Figure 5.2 FIA and AC has a linear relationship. There is a linearity between AC and BS. BC and AC shows a linear trend among themselves. Along with linearity this study also undergo normality and multicollinearity test.

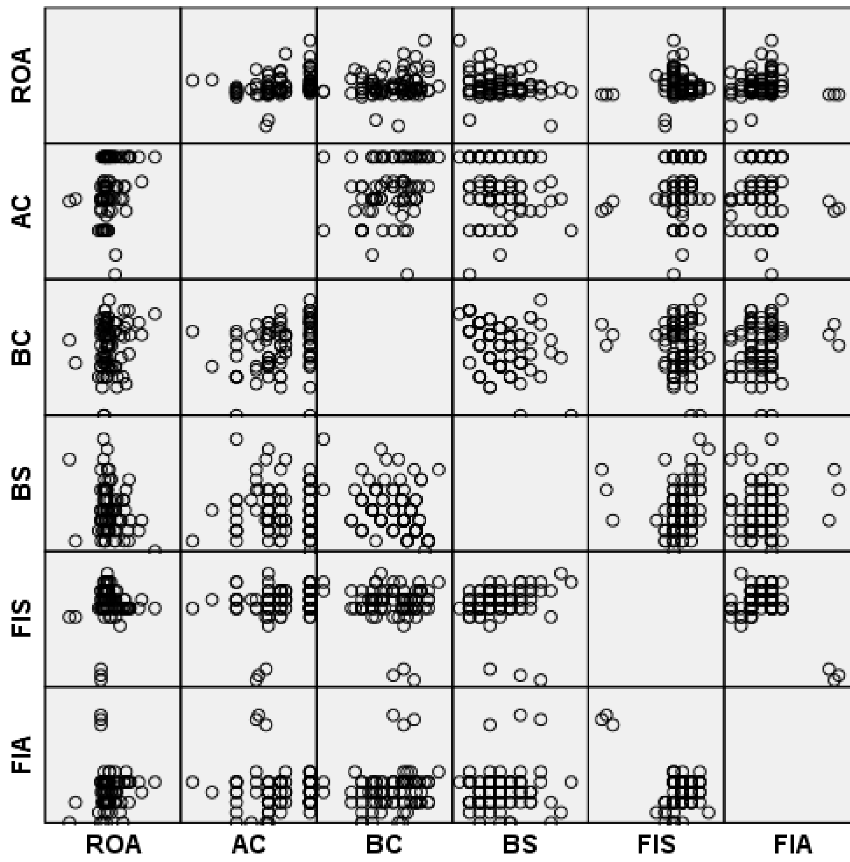


Figure 5.1: Linearity - ROA

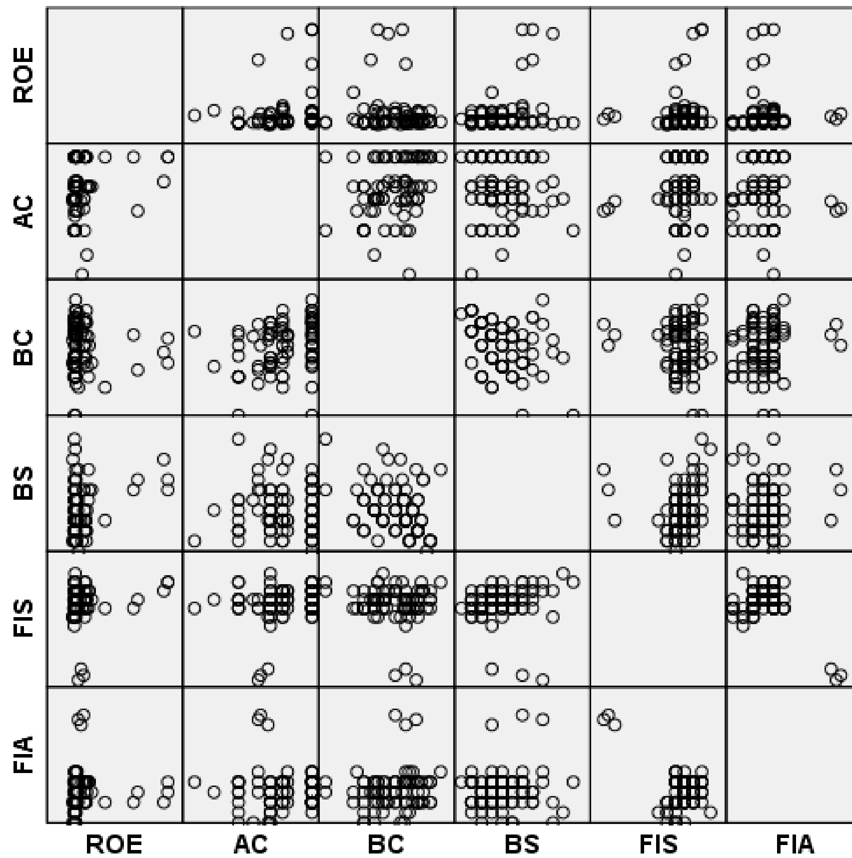


Figure 5.2: Linearity - ROE

5.5.2 Normality Test

5.5.2.1 Quantile-Quantile Plots (Q-Q Plots)

The second assumption of multiple linear regression analysis requires all variables to be normal. This can be checked with Q-Q plot. Figure 5.3 explains data in ROA are normally distributed. In figure 5.4, ROE points shows normal distribution of data. QQ plot of AC, BC, BS, FIS and FIA (Figure 5.5 to 5.9) shows normal distribution. So, this study uses this data for multiple regression analysis.

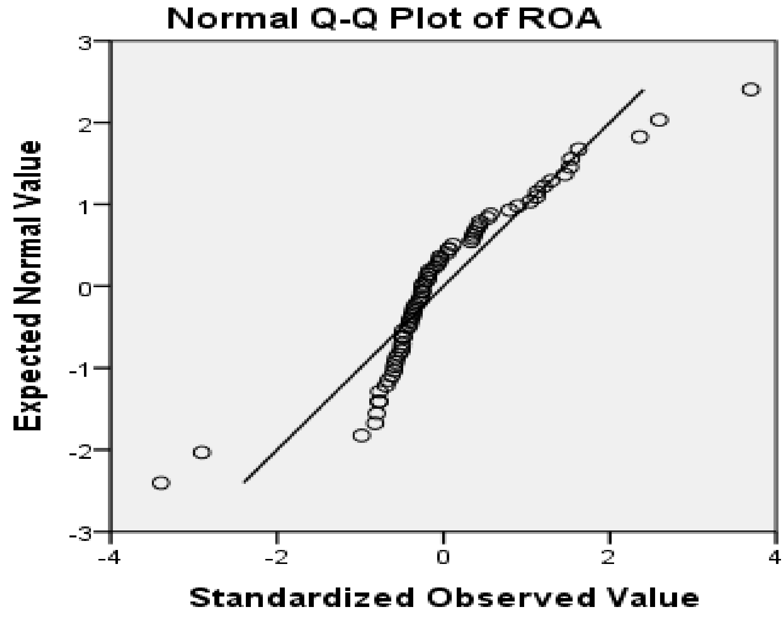


Figure 5.3: Normal QQ Plot – Return on Asset

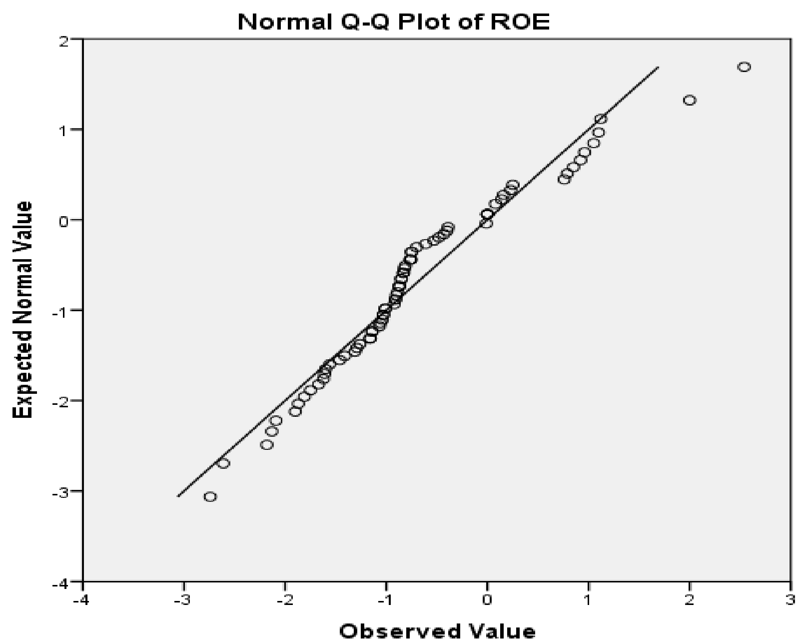


Figure 5.4: Normal QQ Plot – Return on Equity

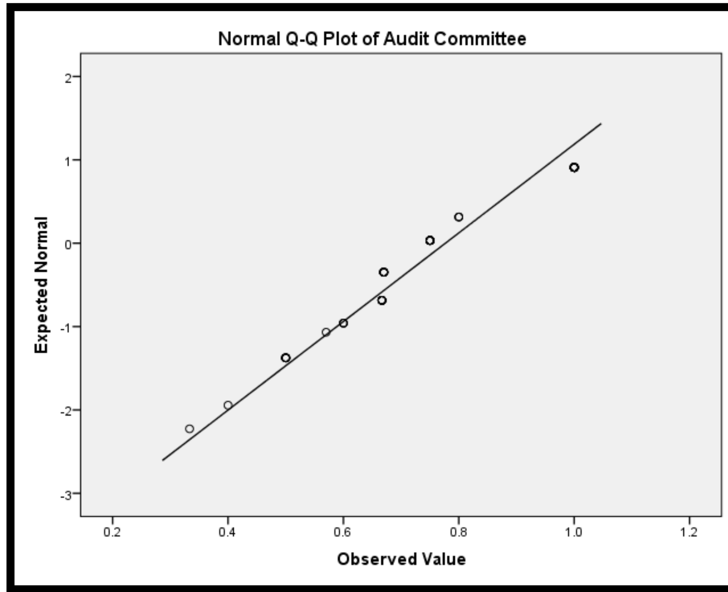


Figure 5.5: Normal QQ Plot – Audit Committee

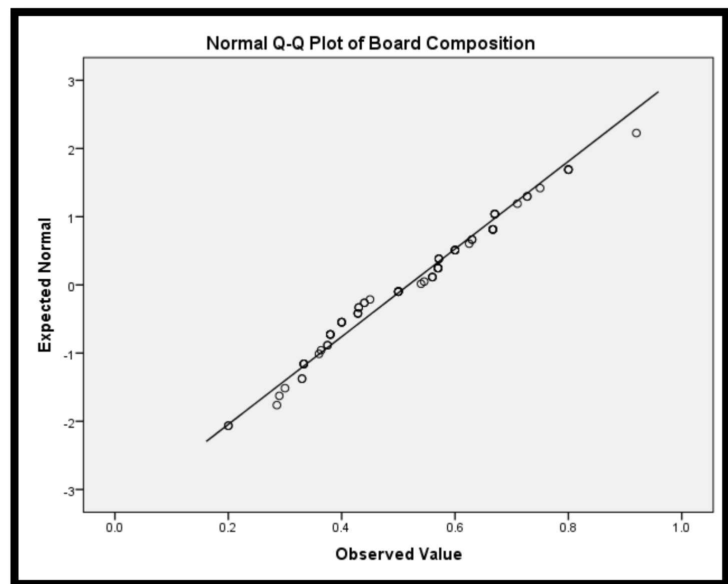


Figure 5.6: Normal QQ Plot – Board Composition

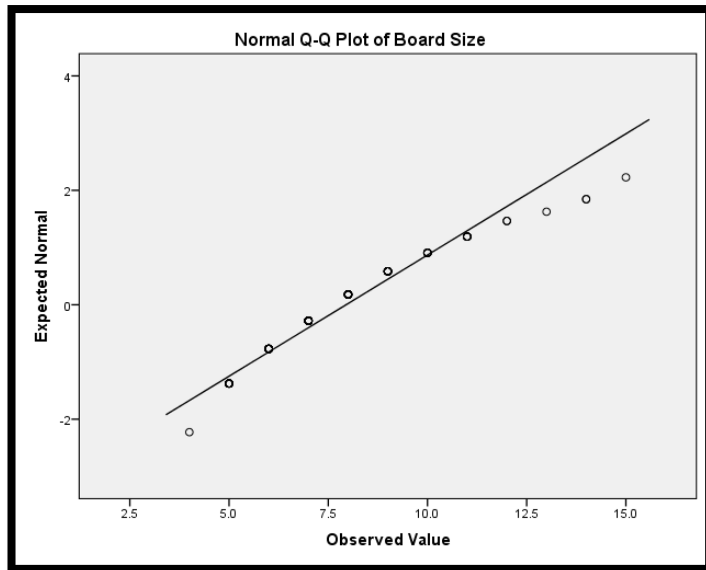


Figure 5.7: Normal QQ Plot – Board Size

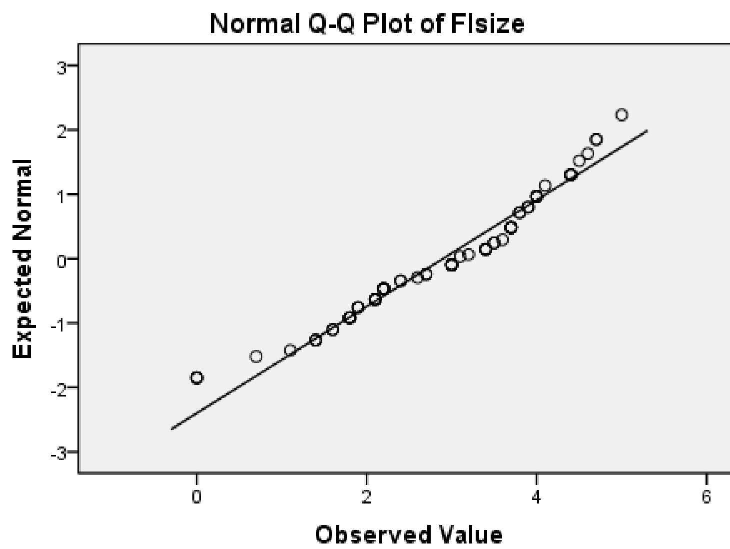


Figure 5.8: Normal QQ Plot - Financial Institutions Size

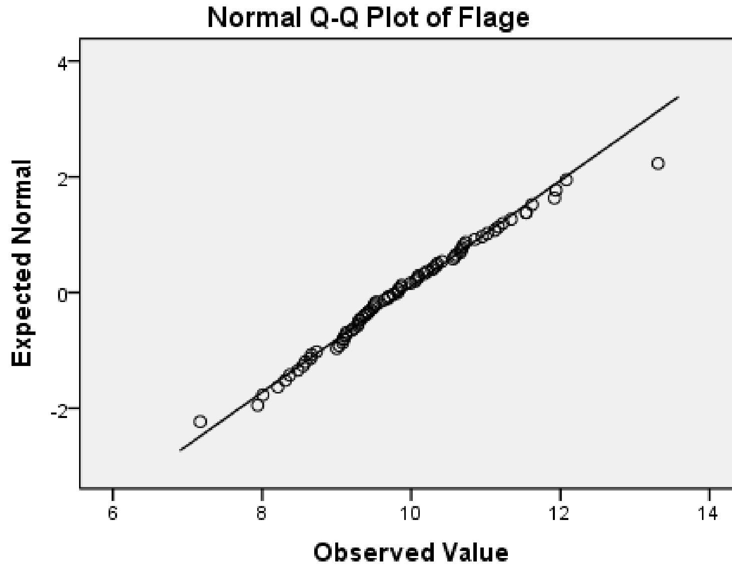


Figure 5.9: Normal QQ Plot – Financial Institutions Age

5.5.2.2 Skewness and Kurtosis Test

Normal distribution of data can also be checked with skewness and kurtosis test. Table 5.5 shows skewness value of ROA to be -1.621. ROE has 0.692 skewness value which is in normal limit. ROA has 5.673 as kurtosis value and ROE has 1.004 kurtosis value. Other variables such as audit committee, board composition and board size are also with in normal limit of skewness that is -0.218, 0.203, 0.896. Kurtosis value of audit committee is -1.037, board composition is -0.493, and board size is 0.651 as shown in table 5.5. The result also indicates that the data are normally distributed since the values for skewness and kurtosis are within the normality range ±1.00.

Table 5.5: Skewness and Kurtosis

	Skewness		Kurtosis	
	Statistic	Std. Error	Statistic	Std. Error
Return on Assets	-1.621	0.274	5.673	0.541
Return on Equity	.692	0.274	1.004	0.541
Audit Committee	-.218	0.274	-1.037	0.545
Board Composition	0.203	0.274	-.493	0.541
Board Size	0.896	0.274	0.651	0.541
Financial Institution Size	-.610	0.274	-.155	0.541
Financial Institution Age	0.364	0.274	0.478	0.541

5.5.3 Multicollinearity

Third assumption of multiple linear regression is multicollinearity. The data was checked for multicollinearity using the test of Pearson's correlation, Tolerance and Variance inflation factor.

5.5.3.1 Pearson Correlation

Table 5.6 present correlation matrix for independent, dependent and control variables. If the variables reveal collinearity among themselves, there would be a biased regression result. Simple correlation matrix is used to test multicollinearity. As table 5.6 exhibits, where ROA is the dependent variable whilst audit committee, board composition and board size are the independent variables. Rule of Thumb is, when the correlation coefficient between two variables exceeded 0.80 or 0.90, there is a potential problem with multicollinearity (Gujarati, 2003). Table 5.6 shows the correlation value less than 0.80, exhibit no issue of multicollinearity in Model 1.

Table 5.6: Pearson Correlation (Return on Asset)

Model 1	ROA	AC	BC	BS	FIS	FIA
ROA	1					
AC	.285*	1				
BC	.224*	.354**	1			
BS	-.201	-.104	-.346**	1		
FIS	.250*	.077	125	.001	1	
FIA	-.121	.010	.060	.493**	.321**	1

** Correlation is significant at the 0.01 level (2-tailed). * Correlation is significant at the 0.05 level (2-tailed).

Note: ROA=return on asset, AC=audit committee, BC=board composition, BS=board size, FIS=financial institution size, FIA=financial institution age.

Consistent with the above, Table 5.7 explains correlation result consisting of ROE to be a dependent variable and audit committee, board composition and board size to be independent variables. Test result shows that none of the correlation value is more than 0.80, hence there is no multicollinearity problem in model 2.

Table 5.7: Pearson Correlation (Return on Equity)

Model 2	ROE	AC	BC	BS	FIS	FIA
ROE	1					
AC	.140	1				
BC	-.057	.354**	1			
BS	.170	-.104	-.346**	1		
FIS	.123	.077	.125	.001	1	
FIA	.271*	.010	.060	.493**	.321**	1

** Correlation is significant at the 0.01 level (2-tailed). * Correlation is significant at the 0.05 level (2-tailed).

Note: ROE=return on equity, AC=audit committee, BC=board composition, BS=board size, FIS=financial institution size, FIA=financial institution age.

5.5.3.2 Test of Tolerance

In multiple regression, tolerance is used as an indicator of multicollinearity. Tolerance is estimated by $1 - R^2$. Most commonly, a value of .10 is recommended as the

minimum level of tolerance (e.g., Adhikari et al. 2015; Haji 2013; Tabachnick & Fidell, 2001). All the values of tolerance presented in Table 5.5 are more than 0.10,which indicates there is no multicollinearity in this study.

5.5.3.3 Variance Inflation Factor (VIF)

The test of multicollinearity is further tested with the variance inflation factor. VIF quantifies as to how much the variance is inflated. VIF measures the impact of collinearity among the variables in a regression model. Values of VIF that exceed 10 are often regarded as indicating multicollinearity. It was mentioned by Haji 2013; Hafsi and Turgut 2013 in their study. Table 5.8 shows that the highest variance inflation factor VIF value is 1.557 which is less than 10. The variance of all predictor variable is more than 1 but less than 5 indicating that the all predictor variables are moderately correlated with other predictors in the model, hence there is no problem of multicollinearity.

Table 5.8: Variance Inflation Factor

ROA & ROE	Collinearity Statistics	
	Tolerance	VIF
Audit Committee	0.873	1.145
Board Composition	0.762	1.312
Board Size	0.642	1.557
Financial Institutions Age	0.649	1.541
Financial Institutions Size	0.634	1.167

The maximum of this VIF is at 1.557 which concludes that multicollinearity is not significant in this study. Therefore, it is estimated that regression results are less likely to have multicollinearity problems among the variables used for this study. This VIF value is consistent with the study of Aburaya, Rania and Kamal (2012) which has mean value of VIF at 1.91.

5.5.3.4 Homoscedasticity

The fourth assumption of multiple linear regression is homoscedasticity. Homoscedasticity is used to find whether the given set of data have similar levels of variance. Figure 5.10, data set is tightly clustered around mean and has a similar variance for all values of variables of model 2 (Return of Asset). Scatterplot shows that the fit line is very flat, that means it has homoscedasticity, hence it ensures this study has a reliable result. The error variable is constant with varying values and it can be concluded that the errors are normally distributed.

Figure 5.10 and 5.11 examine the assumptions of homoscedasticity. It is easily visible that the scatter plot shows data arranged in line of fit which represents the result of model to be validate. The test result proves that the model used for the study is valid. So, this study proceeds with test on multiple regression analysis.

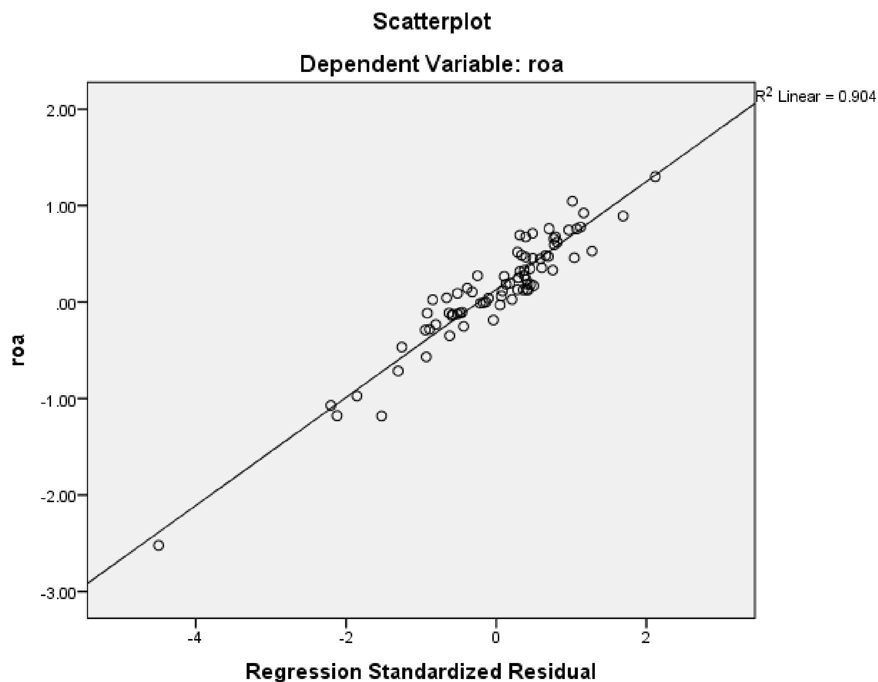


Figure 5.10: Homoscedasticity (Return on Asset)

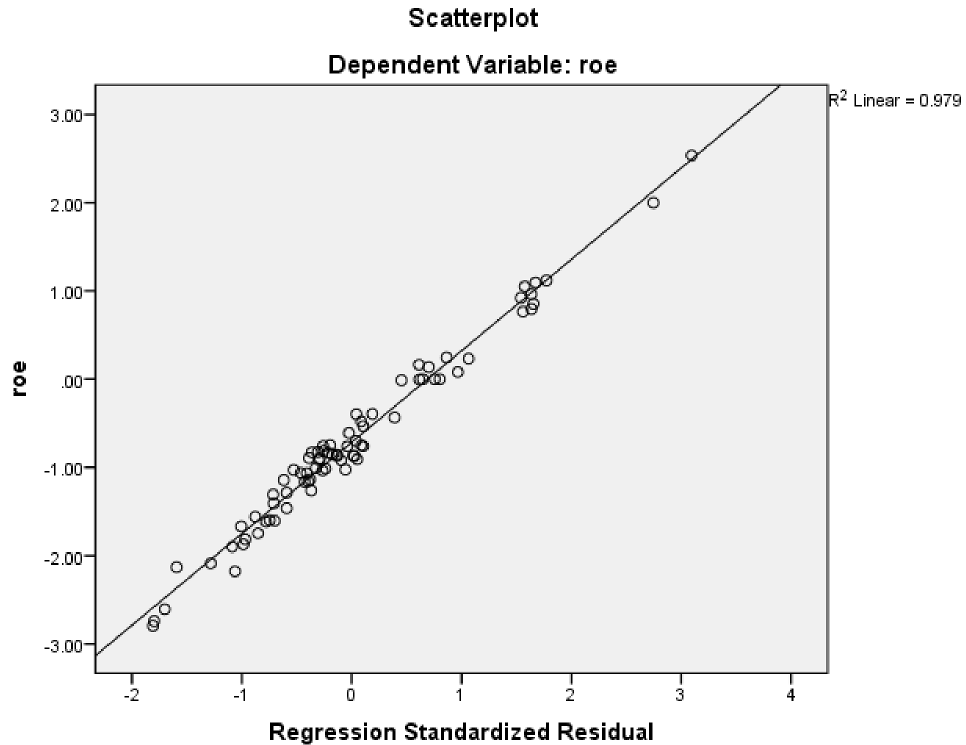


Figure 5.11: Homoscedasticity (Return on Equity)

5.6 MULTIPLE REGRESSION RESULT (RETURN ON ASSET)

Multiple regression technique is used to predict the impact value with ROA based on Eq.(1) $\beta_0 + \beta_1 AC_{x1} + \beta_2 BC_{x2} + \beta_3 BS_{x3} + \beta_4 FIS_{x4} + \beta_5 FIA_{x5} + \varepsilon_x$ developed in section 4.9. Table 5.9 presents multiple regression results for ROA. Table 5.9 represent the P value of audit committee (AC) to be 0.027 which is smaller than common alpha level (0.05). In Table 5.9, multiple regression result shows that the audit committee has a significant relationship with return on asset, suggesting that the model explains variation in ROA. As mentioned in chapter 3, the first hypothesis is, 'there is an association between independent non-executive directors in audit committee and return on asset (ROA)'. So, the first hypothesis has been accepted. It can be concluded that the independent directors in audit committee has an impact on ROA. The directors who works outside are exposed to lot of experience and knowledge, this contributes to the financial performance of financial institutions. This work is similar to similar studies (Arslan et al. 2014; Bouaiz and Triki, 2012; Nuryanah and Islam, 2011; Cohen, 2011) which argues independent directors can have various monitoring processes, keeping in check of the business activities by managers will increase quality of audit and effective financial reporting.

Third hypothesis is, 'there is an association between independent non-executive directors in board and return on asset (ROA)'. Table 5.6 shows coefficient of board composition to be 0.844 which is more than 5% significance level, hence, not significant with return on asset, and reveals these BC has not made variance in ROA. This may be due to more number of independent directors from other field who have less experience in financial institutions. The insignificant relationship indicates that participation of independent directors on board who do not have interest in managing financial institution may affect the profitability level measures by ROA. Hence, the third hypothesis has been rejected. Some consisting result in Malaysia (Annuar, 2012; Meng, 2009 and Ghazali and Weetman, 2006) also found independent directors rarely have influence on decision making. Authors such as (Balasubramanian et al. 2010; Sarkar et al. 2006) opine that quality of board members is more important than their independence.

Hypothesis five mentioned that 'there is an association between board size and return on asset (ROA)'. As revealed in table 5.9, the P value of board size is 0.046 which has significant association with ROA of the sampled financial institutions in Malaysia, that revealed significant changes in ROA based on board size. This seems to agree to the fact that more number of directors in the board does have an impact on ROA. When there is more number of directors in the board, that brings more knowledge, vision, opinion and investment proposal from outside the industry. More directors with experience resulted with better financial performance. The findings support hypothesis 5 of this study, so this hypothesis has been accepted. This finding is consistent with (Saibaba and Ansari, 2012; Ujunwa 2012; Fauzi and Locke, 2012; Belkhir, 2005) who found more number of directors in the board resulted with increased trend in financial performance.

In Table 5.9, P value 0.272 of licensed financial institutions' size (control variable) resulted in a statistically non-significant impact on the ROA. This means that the size of financial institutions does not have an impact on ROA. The second control variable, licensed financial institutions age, resulted in P value of 0.150 that has insignificant impact on the ROA which shows that financial institutions' age has no impact on ROA. In order to show how much effect the control variables itself have an on performance, this study used Eq1 without control variable and Eq 2 with control variable with ROA.

Table 5.9 shows the adjusted R square value without control variable to be 0.094. When we use control variable in the model, the R square value raises up to 0.104. This shows that these independent variables alone have 9% impact with performance.

Table 5.9 Summary of Multiple Regression Result (ROA)

	ROA without CV	**ROA with CV**
AC	.025	.027
BC	.569	.844
BS	.138	.046
FIS	-	.272
FIA	-	.150
R square	.127	.158
Adjusted R square	.094	.104
Sig.	.013	.019[b]
F value	3.843	2.898

Note: ROA=return on asset, AC=audit committee, BC=board composition, BS=board size, FIS=financial institution size, FIA=financial institution age.

5.7 MULTIPLE REGRESSION RESULT (RETURN ON EQUITY)

Based on Eq.2 that is, $\beta_0 + \beta_1 AC_{x1} + \beta_2 BC_{x2} + \beta_3 BS_{x3} + \beta_4 FIS_{x4} + \beta_5 FIA_{x5} + \varepsilon_x$, the impact of CG on ROE is analysed. The result reported in Table 5.10 shows the P value of audit committee to be 0.040 at 5% significance level, resulted with positive and significant association with ROE, suggesting that the audit committee has an impact on ROE. It seems that the independent directors in the board are really independent, and having sufficient knowledge on financial institutions. This result is supported with hypothesis 2, which means there is an association between independent non-executive directors in audit committee and return on equity (ROE). Hence, hypothesis 2 has been accepted. The result of this study is in line with Chand and Li, 2010, who demonstrate that higher levels of independence and expertise on audit committees increase ROE.

P value of board composition in Table 5.10 is 0.376, which shows non-significant impact on the ROE of financial institutions in Malaysia. It was expected that the

independent directors have an impact of ROE, but the result concluded that there is no such impact on ROE and also it has non-significance. The result is in contradiction with hypothesis 4, which stated that there is an association between independent non-executive directors in board and return on equity (ROE). The result shows that the independent non-executive directors being not able to effectively manage the firm may be due to lack of experience and skills. So, the fourth hypothesis also has been rejected. The result is consistent with (Aminu, Aisha and Muhammad 2015; Satirenjit et al. 2015) whose research shows an increase in board composition resulted with decrease in ROE.

It is easily visible in Table 5.10 that P value of board size (0.0.021) is smaller than common alpha level of 0.05 which indicates statistically significant relationship. The sixth hypothesis of the study is 'there is an association between board size and return on equity (ROE)'. Table 5.10 display the result of board size shows that FI size has a positive and statistically significant impact on the ROE of financial institutions in Malaysia. That is, the number of members in the board does have an impact on ROE. It seems when there is more number of directors on board, the board possess new set of skills that will produce benefits. Hence, the hypothesis 6 has been accepted. The same result was found from the studies (Saibaba and Ansari, 2012; Ujunwa 2012; Belkhir, 2005) whose research states that large board size has better ability for decision making and judgement.

Table 5.10 shows the multiple regression run without control variable (Eq3), shows adjusted R square value to be 0.080, which increases to 0.105 when we use the control variable for analysis (Eq4). It shows that control variables have 2% of influence on ROE.

Table 5.10 represents the financial institutions size (P value is 0.310) and financial institutions' age (P value is 0.543) and shows that there is a positive and statistically insignificant impact on the ROE. Also, the asset size of the financial institutions has no impact on ROE and number of years in service also make no changes in ROE.

Table 5.10 Summary of Multiple Regression Result (ROE)

	ROE without CV	**ROE with CV**
AC	.025	.040
BC	.299	.376
BS	.048	.021
FIS	-	.310
FIA	-	.543
R square	.114	.160
Adjusted R square	.080	.105
Sig.	.022[b]	.018[b]
F value	3.383	2.925

Note: ROE=return on equity, AC=audit committee, BC=board composition, BS=board size, FIS=financial institution size, FIA=financial institution age.

5.8 MODEL SUMMARY – Model of Fitness

Table 5.9 shows adjusted R square value is 10%. That is, the explanatory power of the model is 10% with ROA, in the first model. The Table 5.10 shows that there are changes in independent variable which has 10.5% impact on return on equity. This adjusted R square value is greater than the adjusted R square value of Amira & Siti (2014) study result which shows only 2.1%.

5.9 ANALYSIS OF VARIANCE (ANOVA)

When considering ROA, the ANOVA test confirms the goodness of the research model. Table 5.11 resulted with 1% significant value.

Table 5.11: ANOVA Test (Return on Asset)

ANOVA					
Model		Sum of Squares	Mean Square	F	Sig.
1	Regression	75.774	15.155	2.898	.019[b]
	Residual	402.598	5.229		
	Total	478.372			
a. Dependent Variable: ROA					

b. Predictors: (Constant), FIa, BS, AC, BC, FIs

Note: ROA=return on asset, AC=audit committee, BC=board composition, BS=board size, FIS=financial institution size, FIA=financial institution age.

When considering ROE, the results of ANOVA test in Table 5.12 shows the value P 1% significant.

Table 5.12: ANOVA Test (Return on Equity)

ANOVA					
Model		Sum of Squares	Mean Square	F	Sig.
2	Regression	47.189	9.438	2.925	.018[b]
	Residual	248.423	3.226		
	Total	295.612			
a. Dependent Variable: ROE					
b. Predictors: (Constant), FIa, BS, AC, BC, FIs					

Note: ROE=return on equity, AC=audit committee, BC=board composition, BS=board size, FIS=financial institution size, FIA=financial institution age.

5.10 SUMMARY

This chapter has presented the statistical computations on selected mechanisms of corporate governance and financial performance of Malaysian listed financial institutions. The chapter dealt with assumptions of multiple regression analysis, which are linearity, test of normality, skewness and kurtosis test, test of multicollinearity which includes Pearson's correlation, test of tolerance, variance inflation factor and test of homoscedasticity to check the normality of data. The multiple regression result shows that the audit committee and board size have a significant impact with ROA and ROE. Board composition does not have a significant impact either on ROA or ROE. This chapter has also explored the percentage of compliance of GCGLI 2013 by the financial institutions and results showed that majority of financial institutions complied with BNMs guidelines.

CHAPTER 6

FINDINGS, CONCLUSIONS, LIMITATIONS AND RECOMMENDATIONS

6.1 INTRODUCTION

This chapter attempts to outline the findings of this study. It illustrates the profile of licensed financial institutions, findings of the study, contribution to the knowledge, recommendations of the study, limitations of the study, recommendations for future study and conclusion.

The Asian financial crisis 1997-1998 drew attention to the weakness of corporate governance in Malaysia. After the financial crisis, many reforms have been taken to enhance the quality of corporate governance. Corporate governance is closely associated with accountability, transparency, responsibility and disclosure. Financial institutions hold an important role in the financial system of the country, so to strengthen the corporate governance, Bank Negara Malaysia revised the guidelines for financial institutions. Guidelines on CG for licensed financial institutions were rectified by BNM and the amended guidelines were issued in 2013. Based on this all the listed financial institutions are advised to comply with these guidelines with effect from June 2013.

Most of the studies on corporate governance have focused on developed countries like United Kingdom, Germany and Japan to analyze whether the existing CG promotes accountability. A lack of prior academic studies in the area of corporate governance and its financial performance in licensed financial institutions in developing economies like Malaysia was identified. Sound corporate governance ensures trust among investors and stakeholders; whereas poor CG practices affect investors' confidence about reasonable returns on their investment. Hence, it is crucial to analyze the impact of corporate governance on the profitability of licensed financial institutions in Malaysia.

As set out in Chapter 1, the main objective of this study is to determine the impact of corporate governance determinants on the financial performance of banking institutions, insurance companies and takaful operators in Malaysia. The sub-objective is to identify whether the financial institutions comply with Bank Negara Malaysia's revised Guidelines on Corporate Governance for Licensed Institutions (GCGLI) 2013.

This study also used annual report as it data source. The main source of information is secondary data of listed financial institutions for the year 2014, collected from annual reports available in the main market of Bursa Malaysia. There are 115 licensed financial institutions in Bursa Malaysia, among which only 83 financial institutions have made their annual report available in the Website. This achieve a sample size of 72% (83/115), which is acceptable for study of accounting research. The study sample comprised of three important categories such as 45 banking institutions, 28 insurance companies and 16 takaful operators.

Theoretical framework of the study is agency theory examining each research hypothesis testing the association between the three corporate governance variables with financial institutions performance. The three corporate governance variables are audit committee, board composition and board size and the financial institutions is measured by using the return on asset and return on equity. The reason of using the agency theory is because this theory is widely used in the accounting research; it explains the agency problem and agency cost between the principal and agents. The establishment of corporate governance is to reduce the agency cost. Although number of empirical studies have analysed the corporate governance factors using the agency theory as the basis of analysis on performance measures of non-financial companies but very few studies have been conducted in the area financial institutions. Thus, this study add valuable contribution to empirical study in the corporate financial institutions in Malaysia.

The audit committee independence is measured by number of independent non-executive directors serving in audit committee. The second independent variable of the

study is board composition, which is the number of independent non-executive directors on the board relative to the total number of directors. The third independent variable is the board by calculating total number of directors who are serving on the board. The financial performance measure is calculated by using the two dependent variables such as return on asset and return on equity.

To analyze the main research objective, the data were analyzed using the multiple regression analysis. The study has two models, one to analyze impact of CG variables with ROA and the other to find out the impact of CG variables with ROE. The research sub-objective is whether the licensed financial institutions comply with GCGLI 2013 or not, in order to obtain this objective this study used dichotomous scale. Based on this when the financial institutions comply with GCGLI 2013 it is marked as 1, otherwise 0.

6.2 LICENSED FINANCIAL INSTITUTIONS PROFILE

Samples of the study were taken from licensed financial institutions listed in Bursa Malaysia. Data on 83 out of 115 financial institutions were collected through the annual reports (2014) available in main board of Bursa Malaysia. The guidelines on corporate governance for financial institutions were issued in 2013. In order to find the impact of guidelines in corporate governance this study used data from the consequent year, 2014. There were three classifications of financial institutions, they are banking institutions, insurance companies and takaful operators. 55% of data required for the study are derived from banking institutions, comprises of 22commercial banks, 14 Islamic banks, 2 international Islamic banks and 7 investment banks. 33% of data are procured from insurance companies, comprising of 2 life business and general business, 9 life business only, 15 general business only and 2 general reinsurance business. 12% of sample data derived from takaful operators, which includes 3 Takaful operators for family Takaful Business, 9 Takaful operators for Family and General Takaful Business, 1 Retakaful operators for General Retakaful Business and 3 Retakaful Operators for Family and General Retakaful Business.

6.3 FINANCIAL INSTITUTIONS - COMPLIANCES

To examine whether the licensed financial institutions in Malaysia comply with the Bank Negara Malaysia's GCGLI 2013, 45 licensed banking institutions were taken for this study, among which 37 (82%) licensed banking institutions have complied with Bank Negara Malaysia's guidelines viz. GCGLI 2013 regarding audit committee. With reference to the licensed insurance companies 28 (100%) out of 28 companies taken for the study has complied with audit committee requirement issued by GCGLI 2013. 100% (10 out of 10) of takaful operators in Malaysia have complied with Bank Negara Malaysia's guidelines viz. GCGLI 2013 regarding audit committee. Statistical results have stated that, 93% of licensed banking institutions, 96% of licensed insurance companies and 100% of takaful operators in Malaysia have complied with Bank Negara Malaysia's guidelines viz. GCGLI 2013 regarding board composition. Further, it was easily seen from the statistical result that 68% of licensed banking institutions, 64% of licensed insurance companies and 80% of takaful operators in Malaysia have complied with Bank Negara Malaysia's guidelines viz. GCGLI 2013 regarding board size. Overall analysis based on dichotomous scale reveals the mean value of compliance of all financial institutions to be 87%, resulted with majority (87%) of the financial institutions complying with GCGLI 2013.

6.4 DESCRIPTIVE STATISTICS

The descriptive statistics of the study show the mean value of return on asset is 1.96% ranging from -6.4 to 11.1 percentage in the year 2014. ROE is as high as 9.2 percent with a mean value of 0.58%. The descriptive statistics also shows the mean value of audit committee (AC) to be 0.77% indicating that the audit committee is mostly composed of independent non-executive members which complies with code of GCGLI 2013. The mean value of board composition is 0.52%, showing that there is an equal number of independent non-executive directors in the board. Larger number of independent non-executive directors as directed by GCGLI 2013 was put into practice by all the financial institutions in this study. Descriptive statistics also indicates that the mean value of board size 7.9%, that satisfies the required number of members in the board based on previous studies which says the number of board should be under 8 members.

6.5 DATA NORMALITY

Prior to the testing of the association between the independent and dependent variables, all the data were tested for assumptions. The normality assumption is tested using Q-Q plot. Result shows the value of ROA to be normally distributed, data for ROE to be slightly derived from the normality. Through QQ plot, it was visible that all data of the independent variables such as audit committee, board composition, board size and control variables, financial institutions size and financial institutions age has normal distribution of data. The normality of data was also assessed by skewness and kurtosis test. All the variables except ROA shows skewness and ROE show the data to be normally distributed. Regarding kurtosis all the variables other than ROA and ROE were normally distributed.

The variance inflation factor is used to measure the impact of collinearity among the variables. VIF value in the study shows 1.578. When the VIF value exceed 10, there is a chance of multicollinearity; here it is less than 10 shows there is no multicollinearity. The statistical value of tolerance is lower than 10, so there is no multicollinearity problem. To check the assumptions of multicollinearity this study used Pearson's correlation is used. The maximum value of correlation in first and second model between board size and financial institutions size is 0.49, which is less than 10. Hence, there is no multicollinearity among variables used in both models.

6.6 MAIN FINDINGS OF THE THESIS

Linear regression analysis is used to find how much total variation in dependent variable can be explained by independent variable. This study analyzes the main research objective using the multiple regression analysis to know the significant P-value between the dependent variables of ROA and ROE and the three independent variables. The result in the first model (ROA) shows, P value of audit committee to be 0.027, board composition to be 0.844 and board size to be 0.046. When the P value is smaller than the significance level of 5%, this exhibits significance of audit committee and board size with ROA. With regard to board composition P value

represent greater than 5% significant level, so there is a non-significant relationship with ROA.

The regression result of second model consisting ROE as dependent variable shows the P value of audit committee to be 0.040, board composition to be 0.376 and board size to be 0.021. Hence, the P value of audit committee and board size is less than the significance level to be significant with ROE. Board composition shows more than 5% significance level which reveals the non-significance relationship between ROE.

Overall in model 1, using the ROA with three independent corporate governance variables audit committee and board size has significant result. In model 2, audit committee and board size are significant with ROE (adjusted R^2 for Eq.2 is 0.104 and for Eq4 is 0.105). This indicates that among three corporate governance variables, audit committee and board size have a significant influence on ROA. Board composition has no significant influence on the financial institutions performance in Malaysia. The detailed discussion on this significant and insignificant association between the dependent variable (ROE and ROA) and three independent variables (Audit Committee, Board Composition, Board Size) is given in the subsequent section.

6.6.1 Audit committee with ROA and ROE

The Audit committee is the important component of any corporation to uphold the corporate accountability. The prime motive of the audit committee is to improve and strengthen the financial reporting practice and also to ensure the proper conduct of corporate affairs. As stated in the GCGLI 2013, the financial institutions must include majority of independent directors in audit committee. Among the members in the audit committee, the independent audit members in the committee are necessary to ensure and to reduce the likely financial and non-financial incidence and further strengthen the internal control measures.

The analysis of this study revealed that the presence of independent non-executive members in the audit committee has an impact on return on assets and return on equity.

The P value for AC (0.027) with ROA indicate significant relationship. AC and ROE has significant P value of 0.040.

6.6.2 Board composition with ROA and ROE

Independent non-executive directors may effectively influence the board's decision and resulted with effective financial performance. Board composition is a ratio of non-executive and executive directors in the board. Agency theory also recommended for majority of independent directors to supervise and control managers and to minimize the agency cost. GCGLI 2013 advised that the board should have strong independent elements where no individual or small group is allowed to dominate decision making. The independent directors can enhance the accountability and decision-making process. Higher proportion of independent directors could mitigate agency problem and agency cost.

The empirical analysis of this study revealed that the P value between ROA and board composition is 0.844, with insignificant result. With regard to board composition, it has non-significant result with ROE where the P value is 0.376. The insignificant association between the board composition with ROA and ROE is consistent with other empirical studies.

The insignificant association between the board composition of independent directors and the financial performance of financial intuitions' in context of Malaysia may be due to shortage of time after amending GCGLI 2013. GCGLI was issued in 2013, this study is conducted on the immediate next year that is 2014. Hence, it is expected the impact of board composition will be effective after a certain period of time. Even though financial institutions complied with GCGLI 2013, the regression result shows no impact of board independence with ROA and ROE as the revenue of financial institution is mainly driven by deposit of clients and bank investment using deposits through the loan. It is suspected that the independent directors may have committed with other business and they only involve financial institutions as a part-time basis.

6.6.3 Board size with ROA and ROE

Number of members in the board is an important factor in determining effectiveness of management and control. GCGLI 2013 advised the board to have an appropriate number of directors based on their size, complexity, scope and operations of business. Agency theory mentioned the board size to be small for easy control and preventing delay in decision making. The result of this study shows an association between board size and return on asset to be significant because P value is 0.046. Further, regression result between board size and return on equity has the P value of 0.021, which resulted with positive significance.

6.6.4 Control variables with ROA and ROE

Regression results shows the P value of control variable, financial institutions size (0.272) to be not significant with ROA. Result conclude that ROE and financial institutions size has a statistically insignificant relationship with P value of 0.310. Financial institutions' age has insignificant relationship with ROA (p value is 0.150) and ROE (p-value is 0.543). The bank has performance difficulties of generating the assets into cash flow. This has nothing to do with the age or size of the bank.

Overall, the regression result of Eq.2 revealed that there is significant relationship between audit committee and board size with return on asset. In Eq.4, regression results explain significant relationship regarding audit committee and board size.

In summary, even though majority of the financial institutions complying with GCGLI 2013, in the study result confirm the prediction of the agency theory in relation to the significant influence in its financial performance, except board composition.

6.7 SUMMARY OF FINDINGS

The hypothesis results are summarised and presented with its P value. The hypothesis 1 is "H1: There is an association between independent non-executive directors in audit committee and return on asset" it p value is 0.027 and the result of the hypothesis is accepted. In the case of second hypothesis, fifth hypothesis and sixth hypothesis P

values are 0.040, 0.046 and 0.021 are accepted respectively. Hypothesis three resulted with P value of 0.844 and hypothesis four has P value of 0.376 hence these two hypothesis has been rejected.

6.8 CONTRIBUTION TO KNOWLEDGE

This study considers three measures of corporate governance and two measures of financial performance, which is expected to be of help to the researchers in this area of interest. Many previous studies were conducted to measure the relationship between corporate governance variables and financial performance among non-financial institutions in Malaysia. Since to the best of the researcher's knowledge, no study in Malaysia has extensively covered corporate governance of all licensed financial institutions and its financial performance in the year 2014, so this study will serve as a data base for future research.

This study strived to find the impact of corporate governance on financial performance after the implementing GCGLI 2013. Findings of the study provide valuable information on how much audit committee, board composition and board size have any impact on financial performance. It is confirmed by the research the independent directors in audit committee enhance the firms' value regarding ROA & ROE. Findings help businesses to understand the importance of independent directors in audit committee.

Findings shows that independent directors in board does not impact ROA and ROE. It can be easily seen that the negligence of directors in performing their responsibilities resulted with non-significant relationship with board independence and performance. Findings confirm that directors in the board might not provide effective performance through their knowledge and skill in financial business. The result will help BNM to advise directors to devote their time and attention in discharging roles and responsibilities effectively.

Findings highlighted the importance of board size to be in a positive relationship between board size and performance in ROA and ROE. This shows that larger the board size, larger the management, decision making skills and stronger performance.

Findings helps to know whether complying corporate governance did improve financial performance as mentioned by Agency theory. The result confirms majority (87%) of financial institutions have complied with GCGLI 2013 and have positive result in some proxies of corporate governance that improves financial performance. These findings are consistent with Agency theory.

6.9 IMPLICATIONS OF THE STUDY

From the regression result, the importance of independent non-executive directors in financial performance can be easily seen, which is consistent with Agency theory. This study found 94% of financial institutions complying with GCGLI guidelines regarding audit committee. The result confirms that independent directors in audit committee bring new ideas to the audit committee and they are also competent in monitoring managers. Hence, as advised by CGCLI 2013, all financial institutions need to increase the number of independent directors in the audit committee. Audit committee independence is important for the prevention and detection of fraud. More number of independent directors will add value to the financial reporting of the company, which eventually will attract more investors and improve performance. Even though there is 96% compliance with GCGLI 2013 regarding board composition, results from this study confirms that increased number of independent directors doesn't pay off performance. It can also be inferred that the experience and knowledge of independent directors doesn't contribute to monitoring the management or add value to the financial institutions. May be also due to the fact that independent directors in the board are not really independent or do not have sufficient knowledge of day to day operations of the business. Hence a firm can maintain optimal level of board independence with a mix of independent non-executive and executive directors, who are knowledgeable and can make better strategic business decision. To enhance the financial performance, BNM may fix mandatory requirement of qualification and experience for independent directors which will enable them to perform effectively.

BNM can check whether the financial institutions' directors have sufficient professional competence in the financial institutions. Even though board composition has non-significant effect with financial performance, these results cannot be overlooked, as these variables have positive significant association to previous literatures.

This study suggest that board size plays a significant role in financial performance. This underlines the fact that the members of board are highly effective in monitoring management and decision making. It is also found that 71% financial institutions comply with GCGLI guidelines with respect to board size. Larger board size with more diverse set of skills and ideas may be better equipped to obtain information from outside the firm. In the context of financial institutions in Malaysia, larger number of effective board of directors' influence the performance of the institutions.

Currently, all the principles and recommendations of GCGLI 2013 are not mandatory in Malaysia, steps should be taken for mandatory compliance of all codes of corporate governance.

6.10 LIMITATIONS AND RECOMMENDATION FOR FUTURE STUDY

The findings of the study provide extensive evidence regarding compliance of corporate governance mechanisms and its effect on firm performance. However, the researcher found certain limitations of the study.

Firstly, this study would have included all the 115 financial institutions in its study, but, due to non-availability of annual reports, this study had to choose 83 financial institutions as the sample. Future studies can be focused on all financial institutions.

Secondly, this study analyses the contemporaneous effect of CG on financial performance for one year period, which is year 2014. The reason is because in 2015, when the data collection started the only available data after implementation of GCGLI 2013, was 2014. So, this study uses cross sectional data. Further investigation can be

conducted with panel data analysis of corporate governance in long term using data of further years.

Finally, after the implementation of GCGLI in 2013, even though this study sought to analyze data after 2014, due to the short-term study period of one and half years (M.Phil.) it was impractical to collect the data beyond 2014.

6.11 CONCLUSION

The main objectives of the study have been achieved by using Agency theory as a theoretical framework. The four empirical models of the study have achieved their objective effectively in analyzing the impact of corporate governance in financial performance. From the multiple regression analysis, the study therefore concludes that there is significant relationship between audit committee with ROA and ROE. Board size also was found to have an impact on ROA and ROE, but board composition does not seem to have an impact on ROA and ROE. It is expected that future researchers will be able to do further research on the issues highlighted in the study.

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ANNEXURE 1: PRINCIPLES OF CORPORATE GOVERNANCE 2013, MINIMUM STANDARDS AND SPECIFIC REQUIREMENTS – GCGLI Guidelines

Principle 1: Every licensed institution should be headed by an effective board, which assumes specific responsibilities. The vision, strategy and corporate values of the licensed institution should be clearly specified and understood.

Principle 2: There should be an effective board composition, with a strong independent element where no individual or small group of individuals should be allowed to dominate the board's decision making.

Principle 3: There should be a clear division of responsibilities at the helm of a licensed institution, which will ensure a balanced and clear lines of role, responsibility, authority and accountability throughout the licensed institution.

Principle 4: There should be a formal and transparent process for the appointment of directors to the board and the appointment of CEO.

Principle 5: Directors must be persons of calibre, credibility and integrity with the necessary skills and experience and be able to devote time and commitment.

Principle 6: Board should meet regularly and be duly furnished with complete and timely information.

Principle 7: There should be a formal and an ongoing assessment of the effectiveness of the board as a whole, the directors and the remuneration policies and practices should be in line with the licensed institution's ethical values, objectives and culture.

Principle 8: There should be a formal and transparent procedure for fixing the remuneration packages of board members, CEO and senior management, and the remuneration policies and practices should be in line with the licensed institution's ethical values, objectives and culture.

Principle 9: Persons empowered with decision-making authority (including directors) should exercise care to avoid situations that may give rise to a conflict of interest situation.

Principle 10: There should be clear separation between shareholders and management so as not to impede sound corporate governance.

Principle 11: There should be robust auditing requirements and the auditor, board and management need to maintain professional and objective relationships.

Principle 12: Licensed Institution should engage in regular, effective and fair communication with shareholders/stakeholders.

Principle 13: Conducting corporate governance in a transparent manner can reinforce sound corporate governance.

Principle 14: Board is collectively responsible and accountable for the veracity of disclosures and management of risk.

ANNEXURE 2: BOARD COMMITTEES

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Functional Matrix Reporting

2.16 With regard to the functional matrix reporting structure, the Licensed Institution's board and management should ensure that such matrix and business line management structures are consistent with the Licensed Institution's corporate governance responsibilities. The board should ensure that:

- It provides active oversight on the overall operations and performance of the Licensed Institution; and
- The management remains accountable in the running of the Licensed Institution's business operations.

BOARD COMMITTEES

2.17 The board needs to establish specialised board committees to oversee critical or major functional areas and to address matters, which require detailed review or indepth consideration. Although the board may delegate certain duties to the board committees, it remains responsible for the decisions of the committees.

2.18 The board is required to establish the following committees:

- Nominating Committee;
- Remuneration Committee;
- Risk Management Committee; and
- Audit Committee.

ANNEXURE 3: AUDIT COMMITTEE

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AUDIT COMMITTEE

Objective

13. To provide independent oversight of the licensed institution's financial reporting and internal control system and ensuring checks and balances within the licensed institution.

Composition

14. The Audit Committee shall comprise **only non-executive directors** with **at least three members**, of which the **majority** should be **independent directors**. The committee should be **chaired by an independent director**. At least one member should have **accounting expertise or experience in the field of finance**.

ANNEXURE 4: BOARD COMPOSITION

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BOARD COMPOSITION

2.28 Licensed institutions are required to ensure that **at least one-third** of their board members are independent directors. However, in cases where Bank Negara Malaysia has concerns on the effective functioning of the board, a higher proportion of independent directors may be specified by Bank Negara Malaysia. In addition, all resignations and removal of independent directors from the board can only take effect after the respective board has cleared the resignation and removal of the independent directors with Bank Negara Malaysia. This is to ensure the effective functioning of independent directors.

ANNEXURE 5: BOARD SIZE

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Minimum Number of Independent Directors

2.19 The number of directors constituting a board is an important factor in determining the effectiveness of the board in providing direction and guidance to the management of the Licensed Institution and in performing its oversight role effectively. To be effective, the board of a Licensed Institution must have an appropriate number of directors that commensurate with the complexity, the size, the scope and operations of the Licensed Institution. The board should comprise of directors who as a group provide a mixture of core competencies such as finance, accounting, legal, business management, information technology and investment management.

2.20 The board should determine the appropriate size of the board and in determining the size, consideration should be given to enable an efficient and effective conduct of board deliberation.