

The Impact of Board Size on Firm Financial Performance: An Empirical Study of Malaysian Companies

Noor Rohin Awalludin^{1*}, Fatin Afrina Muhammad Razif Fauzi¹, Nisrin Ishak¹

¹ Universiti Poly-Tech Malaysia (UPTM), Malaysia

*Corresponding Author: n_rohin@uptm.edu.my

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Abstract: *This study explores how corporate governance mechanisms namely board size affects the financial performance of firms, as measured by Return on Equity (ROE), in Malaysia. Based on agency theory, which emphasizes the importance of efficient governance in alleviating conflicts between shareholders and management, this study evaluates whether the element can improve firm financial performance within an emerging market framework. A dataset comprising 45 observations from nine Malaysian firms for a period of five years which are from the year 2019 to 2023 was examined using regression analysis in STATA to determine the connections between the governance factors and ROE. The findings reveal a board size showed an insignificant positive relationship with ROE, implying that merely increasing the size of the board does not necessarily lead to enhanced firm financial performance, potentially due to inefficiencies associated with larger boards. This study adds to the existing body of knowledge on corporate governance by offering insights pertinent to the Malaysian environment, with relevance for policymakers and corporate governance practices in emerging markets. Limitations such as sample size and the cross-sectional nature of the study are acknowledged, along with suggestions for future research to examine additional governance factors and longitudinal data.*

Keywords: Corporate governance, financial performance, agency theory, Malaysia

1. Introduction

Over the years, Malaysia has implemented various corporate governance reforms, which have been further enhanced. The regulatory framework for companies established in Malaysia is governed by the Companies Act 2016. Since its introduction in 2000, the Malaysian Code on Corporate Governance (MCCG) has played a crucial role in driving corporate governance reform and has had a positive impact on the corporate governance practices of companies. The MCCG embodies global principles and internationally accepted corporate governance practices that exceed the minimum requirements set by law, regulations, or those stipulated by Bursa Malaysia Berhad (Malaysia's stock exchange). It underwent reviews in 2007 and 2012 to ensure its continued relevance and alignment with globally recognized best practices and standards. In April 2017, the MCCG was updated to adopt a new approach aimed at fostering a more entrenched corporate governance culture.

The aim of this study is to examine the impact of corporate governance on financial performance of firms in Malaysia. Corporate governance refers to the transparency and honesty with which organisations operate. In 2002, the Cadbury Committee of the United Kingdom

described corporate governance as a mechanism for directing and controlling corporations. The corporate world prioritises transparency, accountability, and meeting stakeholder expectations. Corporate governance can help achieve this goal and protect stakeholder interests. The role includes upholding ethical behaviour and promoting legal compliance. Corporate governance prioritises resource efficiency and accountability for their stewardship. The three fundamental constituents of corporate governance are shareholders and the board (Aggarwal, 2013).

Recently, the term “corporate governance” has been refined. According to Chen (2023), corporate governance is a set of policies, procedures, and guidelines that steer and manage a business while weighing the interests of various stakeholders, including lenders, shareholders, management, employees, and the community.

The board of directors creates a framework for corporate governance, according to Lutkevich and Lewis (2022), which promotes the values of security, transparency, equity, compliance, reliance, and accountability and synchronises business conduct with corporate objectives. Key stakeholders' behaviour is influenced by an efficient corporate governance system, which encourages moral decision-making and the production of long-term value. To reduce hazards, improve company transparency, and ultimately achieve long-term success, risk management is essential for discovering, evaluating, and managing risks (iDeals, 2023).

Corporate governance has gained attention in the past decade due to scandals and collapses, like Enron, WorldCom, and Satyam, involving unethical business practices. Corporate governance and value generation are frequently cited as being inextricably linked. A corporation cannot succeed unless it accepts and exhibits ethical conduct. Research on corporate governance and financial performance has yielded conflicting and inconclusive results (Aggarwal, 2013).

However, ESG's ascent, director expectations, and exposure to digital media are drawing attention to the company's failings and emphasizing the need for greater accountability and transparency. Furthermore, as corporate governance lowers compliance risks, dissuades unfavorable assumptions, fosters diversity, ecological credentials, and equitable supply chains in all of which make it a major differentiator for businesses in the eyes of investors as it is imperative in today's cutthroat global economy (Vistra, 2022).

The changing landscape of corporate governance in Malaysia poses substantial obstacles to business financial success. Key concerns include the reactive character of governance policies, inconsistency in regulatory execution, and insufficient communication between regulatory authorities and firms. These problems contribute to inefficiencies in governance practices, which may jeopardize business financial performance and long-term profitability (Yeoh, 2023).

While there is proof that corporate governance can improve financial performance, many Malaysian companies struggle to consistently enforce and follow governance regulations. Variances in transparency, diverse board structures, and challenges in aligning CEO pay with long-term performance goals contribute to this issue. Identifying the specific governance structures that drive financial prosperity and the barriers hindering their broad acceptance by companies is the primary obstacle. Even with established frameworks like MCCG, businesses demonstrate variation in how they apply and uphold governance standards, especially concerning transparency and the independence of the board. Maintaining healthy governance relies heavily on the independence of board members. When there is a lack of independent

monitoring or a diverse board of directors, it can lead to conflicts of interest or inadequate governance in numerous Malaysian companies.

For instance, the 1Malaysia Development Berhad (1MDB) crisis is one of the most serious corporate governance breaches in Malaysia. It entailed extensive financial mismanagement, fraud, and corruption at a state-owned investment corporation. The scandal led in billions of dollars in debt, a loss of investor confidence, and serious harm to Malaysia's reputation, all of which impacted the financial performance of enterprises linked with the fund (Yeoh, 2023). In addition to that, Sapura Energy experienced financial issues because of inadequate corporate governance procedures, such as excessive debt accumulation and ineffective oversight. The corporation experienced severe financial losses, necessitating a massive reorganisation effort. Poor governance harmed investor confidence and share prices, possibly necessitating a bailout by government-linked enterprises (Yeoh, 2023).

2. Literature Review and Hypotheses Development

Corporate governance is defined as a framework of rules, practices, and processes by which companies are directed and controlled. Agency theory provides the foundation for understanding the relationship between shareholders (principals) and managers (agents). The theory emphasizes how governance mechanisms, such as board structure, mitigate conflicts of interest and reduce agency costs.

Prior studies have reported mixed results on the relationship between board size and financial performance. Bhagat and Black (2002) found no significant correlation, while Kalsie and Shrivastav (2016) observed a U-shaped relationship. Similarly, studies on board independence such as Zabri et al. (2016) and Hermuningsih et al. (2020) demonstrated that independent boards enhance firm performance, whereas others found no relationship. This inconsistency highlights the need for localized evidence, particularly in the Malaysian context.

The recent shift towards compliance and best practices in corporate governance is prioritising the quality of board directors rather than the quantity of board directors. The emergence of new best practices has prompted a significant number of individuals to question the effectiveness of large boards in comparison to smaller groupings of board directors. According to a recent study and emerging trends, contemporary boards of directors are recognising the continued relevance of larger board sizes, but overall, they are embracing the concept that having fewer members is more effective in the long run. Modern boards should prioritise diversity and independence as their primary goal, giving less weight to the number of board seats (Diligent, 2017).

When evaluating board numbers and composition, it is important for boards to cater to the specific requirements of their company. The optimal number of board directors required for a firm to achieve its highest level of performance is influenced by various factors, including the company's size, industry, strategic needs, and stage in the economic cycle. Businesses undergo evolution, necessitating a constant assessment of the optimal number of directors required. As exemplified by prominent firms like Apple, Netflix, Toyota, and Honda, reducing the size of the board can be a wise decision (Diligent, 2017).

It is important to note that reducing the size of a huge board can be a process that spans multiple years. It is typically most advantageous to allow it to occur naturally through attrition. When the incumbent directors leave or their terms end, the board does not appoint new directors to

replace them (Diligent, 2017). For instance, a board size is composed of chosen directors chosen by shareholders to manage the business's activities. These managers oversee the day-to-day operations of the organisation and manage its finances in accordance with established policies. This is a fundamental internal control mechanism that has been employed to restrain the actions of senior management to safeguard the interests of investors (Alabdullah, 2020).

A study made by Alabdullah et al. (2022) indicated a favourable correlation between the size of the board and return on equity (ROE). Bigger boards offer a variety of expertise and viewpoints, which enhance strategic decision-making and oversight, resulting in better financial outcomes, such as increased ROE. This was supported by another study made by Amba (2014) in which a bigger board correlates with improved ROE, as it offers a wider foundation for decision-making and effective oversight. This connection is due to the increased capability for overseeing management activities, ensuring that decisions align with the interests of shareholders. Bahar and Herliansyah (2023) also observed a positive correlation between political ties and return on equity (ROE). Companies that have board members or executives with political affiliations often enjoy more favourable regulations, improved access to resources, and possibly reduced operational risks. These benefits lead to an increase in ROE by decreasing costs and boosting profitability.

According to Orozco et al. (2017) in a study with a sample of 84 companies discovered that firms with extensive boards generally exhibit lower financial problems compared to firms with smaller boards. This research explores how board size influences firm performance, particularly ROE, in companies located in Colombia. The results indicate that while there is a positive effect of board size on ROE, this effect diminishes as the size increases. Initially, smaller boards tend to enhance ROE because they allow for more effective decision-making and reduced conflict. Nonetheless, as the size of the board expands, the benefit on ROE decreases, implying that there is an optimal board size at which the advantages of performance are balanced with the efficiency of coordination.

Study by Kalsie and Shrivasta (2016) examined how the size of a board correlates with a company's performance, particularly focusing on ROE, among firms listed on the National Stock Exchange (NSE) in India. The findings reveal a U-shaped non-linear relationship between board size and ROE. Initially, smaller boards show greater efficiency, resulting in higher ROE due to their ability to make faster decisions with minimal coordination. However, once the board size exceeds a certain threshold, the study observes that the positive impact on ROE resurfaces, as larger boards contribute a range of diverse skills and expertise that improve oversight and strategic decision-making.

Based on the literature, the study proposes hypotheses:

H1: There is a positive relationship between board size and firm financial performance.

3. Methodology

3.1 Research Design

This study relied on a quantitative design. This study mostly used statistical analysis and tables. The firm's performance was evaluated using data from its annual report and corporate governance report. To address the potential limitations of this study, it was crucial to select a well-suited strategy to achieve the research goals (Altinay & Paraskevas, 2008). A quantitative research method employed in this study was observations. The research design serves as a

fundamental proposal outlining the methods and procedures for gathering and analysing necessary information (Trevena et al., 2013).

3.2 Sample and Data Collection

The population typically encompasses all individuals, events, or organizations of interest to the researcher (Sekaran et. al., 2003). For this study, the population consisted of the top 10 top-performing stock firms from Bursa Malaysia Listings for five years period of 2019 – 2023. Firms with insufficient data were excluded rather than substituted to maintain the integrity of the data. After the data collection, it was found that only nine companies were suitable as research samples.

All 10 firms are as below:

1. YTL Power International Berhad (YTLPOWR)
2. YTL Corporation Berhad (YTL)
3. Malayan Cement Berhad (MCEMENT)
4. IOI Properties Group (IOIPG)
5. Hartalega Holdings (HARTA)
6. UMW Holdings (UMW) - excluded due to no access to data
7. KPJ Healthcare (KPJ)
8. Fraser & Neave Holdings (F&N)
9. Malaysia Building Society (MBSB)
10. United Plantations (UTDPLT).

3.3 Data Analysis

The analysis of the data will involve using the STATA software to establish the connection between corporate governance practices and firm financial performance. This investigation will utilize both descriptive and correlation analysis. These statistical examinations are essential for evaluating the relationships between variables and aggregating them as they reflect the fundamental attributes of a data set.

4. Results and Discussion

The coefficient of 1.07 for Board Size indicates a positive correlation with Firm Financial Performance, suggesting that a one-unit increase in Board Size would, in theory, result in a 1.07-unit rise in Firm Financial Performance, provided Board Independence stays unchanged. Nevertheless, the p-value of 0.335 reveals that this correlation does not reach statistical significance at the 5% level. This high p-value suggests that Board Size does not have a consistently reliable effect on Firm Financial Performance within this dataset. Statistically, a non-significant p-value indicates that we fail to reject the null hypothesis, implying we cannot assert with confidence that Board Size has a meaningful link to Firm Financial Performance. This may be attributed to significant variability in Board Size or other unmeasured factors influencing Firm Financial Performance that are not accounted for in the model. The 95% confidence interval for Board Size spans from -1.15 to 3.29, which includes zero. This further substantiates the conclusion that Board Size's influence on Firm Financial Performance may lack practical significance. A confidence interval encompassing zero indicates that the true impact of Board Size could vary from a slight decline to a moderate increase in Firm Financial Performance, reiterating the uncertainty surrounding Board Size's effect on Firm Financial Performance.

The regression equation is as follow;

$$Y \text{ predicted} = b_0 + 1 * x_1$$

$$\text{Firm Financial Performance Predicted} = -24.48498 + 1.07$$

The coefficient is 1. Hence, for every unit increase in Board Size, a 1.07 unit rise in Firm Financial Performance is predicted.

The relationship between Board Size and Firm Financial Performance was found to be positive; however, this effect lacked statistical significance, suggesting that Board Size does not exert a consistent or impactful influence within this sample. Conversely, Board Independence demonstrated a strong and statistically significant positive relationship with Firm Financial Performance, underscoring its role as a crucial determinant of financial success. The impact of Board Size remains ambiguous. The model yields valuable insights but indicates a need for further investigation into additional variables that could better clarify the variance in Firm Financial Performance.

5. Conclusion and Implications

This study concludes that board size exhibits an insignificant relationship. The results highlight the importance of independent directors in enhancing board effectiveness and aligning managerial decisions with shareholder interests. The board size did not reveal a statistically significant impact on ROE ($p = 0.335$), even though the coefficient remained positive. This outcome suggests that while board size may play a role in governance structures, it does not consistently improve firm financial performance on its own. These findings have several implications for policymakers, regulators, and practitioners.

The significant influence of board size on ROE adds a more complex understanding of agency theory within the Malaysian context. Although a larger board can improve governance by bringing together diverse skills and viewpoints, it may also introduce inefficiencies, such as delayed decision-making and issues with coordination. This result resonates with studies from other emerging markets where the optimal size of a board differs, indicating that a board that is too large might weaken the individual members' contributions. Furthermore, some research suggests that larger boards may struggle more with reaching agreement.

Objective	Hypothesis	Finding
To examine the effect of board size with firm financial performance.	There is a positive relationship between board size and firm financial performance.	Hypothesis ACCEPTED . There is an insignificant positive relationship between board size and firm financial performance.

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Conflict of Interest Statement

The authors declare that there is no conflict of interest regarding the publication of this study.

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