

## Impact of Corporate Governance on Diversification in Finance Companies: Evidence from Malaysia

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**Abstract.** The board of directors performs a very important role in formulating and monitoring the strategy of a company. Recent development in technology and the change in business environment as well as change in the nature of demand by customers has necessitated the change in the products and services offered by finance companies. Based on data from finance companies listed on Bursa Malaysia over the period 2007 to 2011 this paper examined the impact of board attributes and ownership structure on the corporate strategy of finance companies in Malaysia. The result indicates that expertise of directors and past performance is significant and negatively related with diversification. The study contributes to the literature on corporate governance of finance companies in relation to their diversification strategy and has highlighted the corporate governance mechanisms and regulatory measures appropriate for the sector in order to enhance monitoring so as to achieve sustainable economic development.

**Keywords.** Board attributes, ownership structure, diversification strategy, finance companies.  
**JEL.** E62, H54, O40.

### 1. Introduction

Recent development in technology and the change in business environment as well as change in the nature of demand by customers has necessitated the change in focus of finance companies and change in products and services offered by those companies (Westman, 2009). This change led to financial innovation which has increased risks in businesses and therefore requires more monitoring of the finance companies by directors with necessary attributes to monitor the companies. The global financial crisis, Asian financial crisis and the corporate failures have highlighted the importance of governance mechanisms and necessitated the need for closer monitoring of financial institutions and reforms in corporate governance by regulatory authorities (Becht, Bolton & Roel, 2012). The reforms resulted in enactment of several codes and principles such as the Sarbanes Oxley's Act of 2002 in the United States. In the United Kingdom, several committees such as Hampel committee, Greenbury, Cadbury were formed to look at different aspects of corporate governance such as issue of directors' remuneration, board subcommittees and the financial aspect of corporate governance (Leuz & Wysock, 2008). One of the requirements common in most of those corporate governance movements is the need for strengthening the role of the board. One of the issues that led to corporate scandals, financial crisis in Asia and the recent global financial crisis was the weaknesses in the corporate governance

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mechanisms and the change in focus by the companies (Erkens, Huang & Matos, 2009; Barney, 2009; Mohamad & Sulong, 2010).

The finance sector was not left out of the effects of the dynamism of business environment that resulted into the development of new products and services by the finance companies (Walter & Saunders, 2011). These inventions made regulators everywhere in the world to devise measures that will assist them to assess the changes and come out with rules to cope with the rapid growth and changes in products that were made available to customers through the non-traditional banks (Jones 2000; Gopinath, 2008). International waves of crisis have also affected the finance industry of different countries such as Brazil, Mexico, Russia, Malaysia, Philippines, Indonesia, Thailand and some other Asian countries (Bazdresh & Werner, 2000). These crises motivated some of the firms to diversify their activities in order to diversify their source of revenue and to prevent the adverse effects of a decline in one segment or sector of the economy from affecting the overall firm performance. In regulated industries, the activities of firms are highly regulated and influenced by the regulators. These limit the strategic options available to such firms and sometimes take away the responsibility of selecting the appropriate strategic direction for the firms from the board of directors to the regulators since the regulators have to approve major strategic choices made by the firms (Lang & Lockhart, 1990). This could reduce the level of involvement of directors and management in finding or selecting the appropriate strategies and responding quickly to changes in the industries which arise due to technological advancement and changes in the environment. On the other hand, in less regulated industries there is high competition, sudden changes in the market and threat from new entrants which make firms to continuously struggle to stay ahead of competition. Therefore, directors and management in those firms have to be actively involved in advising on the strategic choices which will enhance firm performance and give it competitive advantage. As a result of competition and changes in business environment, firms need to have directors who will act as providers of resources which are not available internally to the firms (Hillman, 2005). In other words board need to appoint directors that will help improve the companies' position and competitive advantage.

The existence of a sound financial system is needed for the attainment of the status of a developed economy. Such sound financial system mobilizes and allocates funds to various sectors of the economy that helps to lower the cost of capital to the firms, boost capital formation and stimulate productive activities and growth in the economy (Becht et al. 2012). The position of finance companies in an economy is central to the accomplishment of the economic goals of the country (Sufian & Habibullah, 2013). Therefore, poor governance in finance companies could come with great loss to the entire economy in the form of huge expenditure to rescue finance companies and failure to accomplish economic goals that are accomplishable only through the financial system (Thillainathan, 1999). Finance companies are the main depository of the economy and this makes their performance through enhanced governance practices a very vital issue to the economy and different from other sectors of the economy (Becht et al. 2012). The recognition of these and the recurring problems such as the banking crisis of 1980s, the Asian financial crisis and the recent financial crisis in the sector made regulators to continuously update the regulatory requirement concerning corporate mechanisms such as board of directors. Performance of finance companies is of great importance to the Malaysian government. Apart from investments in the sector, the sector is used by the government for the implementation of economic programmes such as National economic policy, 1971 (NEP)/National development policy 1991 (NDP) by providing funds and extending loans through the sector to the

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intended economic sector (Kim & Rasiah, 2010). Furthermore, the contributions of the finance sector to the Malaysian economy is substantial which is second after manufacturing sector in terms of gross domestic product (Economic Planning Unit, 2011).

Several contributions have been made on the board-strategy field, however, there is no clear answer on how board attributes contributes to strategy and therefore there is the need to develop a better understanding of how board attributes contributes to strategy by looking at how board attributes influence the relationship between board of directors and strategy (Pugliese et al., 2009). Although prior studies have examined the impact of corporate strategy on firm performance, less attention has been given to the factors that determine the adoption of a particular strategy by a finance company. Thus, this study examines the impact of board attributes and ownership structure on diversification strategy of finance companies in Malaysia. The result of the study indicates that attributes of board of directors' influence the strategy of finance companies. The study will enable management to ensure that companies have board with attributes that are in line with their corporate strategy. The rest of the paper is organized as follows; section two contains a review of literature while section three presents hypothesis development. Section four explains the research methodology; the presentation and discussion of the result was done in section five while section six and seven contains results from additional analyses and conclusion of the study respectively.

### 2. Literature Review

Strong competition among finance companies and the need to reduce the volatility of the revenue of finance companies has resulted in the diversification of finance companies into other segments of the finance industry. This leads to an increase in revenue of the companies due to additional sources and stability of the revenue of the companies since the income from non-traditional sources (fee based services) is not subject to the business conditions which affect the traditional sources of revenues (Stiroh, 2004). Stiroh (2004) examined the impact of diversification among US banks and the results indicate reduction in volatility of net interest income and that diversification is associated with high risk and low profit implying that financial institutions derive low benefit from diversification. Stiroh (2006) examined the determinants of risk in US bank holding companies based on the period of observation from 1997 to 2004 and reported that diversified activities in the banks are highly volatile, creates difference in the risk level among the financial institutions and leads to complexity in the operations of the firms. Rose (1989) examined the impact of diversification on risk in banks and found that diversification of banking activities into other activities particularly insurance helps reduce risk in banks.

Using a sample of 370 finance firms and 1000 mergers in the period from 1971 to 1987, Boyd, Graham & Hewitt (1993) examined the effect of merger between banking and non-banking holding firms, the result depicts that the merger of banking firms with insurance firms may reduce risk while merger of bank holding firms with securities firms and real estate firms may increase risk. In addition, Strioh & Rumble (2006) examined whether diversification has led to improved performance of US financial holding companies based on the period from 1997 to 2002. They found that firms drive benefits from diversification but the benefit is removed by the extra risk to which the firms are exposed due to the volatility of the non-traditional activities which may not be more profitable than the traditional activities. DeYoung & Roland (2001) examined the impact of product mix on earnings volatility of 472 US banks based on the period 1988 to 1995 and reported

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that based on the result of OLS regression, although diversifying from the traditional business of the finance company was aimed at increasing and ensuring stability of the revenue, high reliance on non-interest income will reduce the benefit derivable from the change in focus as a result of higher risk for the companies and increase in volatility of the revenue.

In addition, Acharya, Saunders & Hasan (2002) examined the impact of diversification and focus on the performance and risk of 105 banks in Italy based on data for the period from 1993 to 1999 and concluded that diversifying assets of a finance firm will neither enhance performance nor reduce risk because a firm may diversify into areas it has less competitive advantage and that the impact of diversification depends on whether it is industrial, sectoral or geographic diversification. Furthermore, Stiroh & Rumble (2006) argued that the cost associated with increased risk of diversified activities will outweigh the benefits of such diversification. Park & Jang (2013) examined the impact of both related and within industry diversification on performance on a panel data of 288 firms in the US restaurant industry over the period 1980 to 2008. The results based on GMM found that within industry diversification is significant and negatively related with profitability in the short run but positive and significant in the long run. They also found that diversification may enhance firm performance only at high levels of diversification because of the negative effect of diversification when it is at low level. In addition, at low level of related diversification, the related business risk is higher than the expected risk reduction that could result from diversifying the businesses.

Other prior studies have shown that diversifying activities of finance companies into non-traditional activities is beneficial because of the increase in revenue (Rose, 1989), reduction in risk due to diversified portfolio (Saunders & Walter, 1994) and reduced possibility of bankruptcy (Boyd & Graham, 1988; Boyd, Graham & Hewitt, 1993). Chen & Yu (2012) examined the relationship between managerial ownership, diversification and firm performance from a sample of 98 firms listed on Taiwanese stock exchange from 1996 to 2001. The regression results revealed a positive relationship between diversification and short term firm performance but no impact on performance in mid-term and added that firms using unrelated diversification strategy perform better than those pursuing related diversification strategies. From agency theory perspective, diversification may create further agency problem between the management and the shareholders when managers diversify in order to get personal benefit at the expense of the shareholders (Ataullah, Davidson, Le & Wood, 2012). Conversely, based on a study of the impact of diversification on the value of a sample of firms, Graham, Lemmon & Wolf (2002) reported that diversification does not create agency problem and it does not destroy value. This argument has been proven by Ataullah et al. (2012) who reported that the level of purchase of firms shares by insiders increase with the extent of corporate diversification which shows that insiders do not pursue diversification with the aim of value destruction.

Other empirical evidence has shown that profitability of focus banks is higher than diversified banks (Laeven & Levine, 2007) while Stiroh, (2004) and Stiroh & Rumble (2006) found that diversified banks are more profitable than non-diversified banks. Mercieca, Schaeck & Wolf (2007) also found similar result in a sample of small European banks. Furthermore, Stiroh & Rumble (2006) found that the cost associated with increased risk of diversified activities outweighs the benefits of such diversification. In addition, they argued that diversification alone will not enhance performance but other factors such as managerial skills, scale, location or industry factors may influence performance.

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Directors provide a firm with knowledge, information and link to resources. From resources dependence theory perspective, directors provide a firm with resources which are not otherwise available (Pfeffer & Salancik, 1978). The strategy of a firm is initiated and implemented by the management while the board of directors approves and monitor the strategic choices (Fama & Jensen, 1983). Based on resource dependence theory, directors contribute to strategic decision making by providing access to resources which the firm needs (Pfeffer & Salancik, 1978). On the other hand, involvement of board in strategy may destroy value (Fulghieri & Hodrick, 2006). The role board of directors plays in a firm and how it perform the functions stipulated by the regulators is influenced by the firm and industry characteristics (Pugliese, Minichilli & Zattoni, 2014). Therefore, boards of firms in highly regulated industries such as finance industry provide more monitoring and advice to management compared to boards in firms operating in less regulated industries. From resource dependence theory perspective, board of directors are assets of the firm which contribute to value creation by providing access to resources which the firm may not have access to (Hillman, Withers & Collins, 2009). Board of directors provide very important role in firms which from agency theory perspective includes monitoring managers and firm performance and from resources dependence theory includes providing advice and access to resources (Hillman & Dalziel, 2003). The advice provided by the board could be advice on strategy, participation in decision-making and supervising the implementation of the strategic choices (Pugliese et al., 2014).

According to Pfeffer & Salancik (1978) board of directors provide the firm with ‘advice and counsel, access to information, preferential access to resources and legitimacy. The board of directors performs a very important role in formulating the strategy of a company. Board of directors by definition refers to the internal governing mechanism that shapes the firm’s governance through advice and monitoring of management (Aguilera, Desender & De Castro, 2011). Zahra & Pearce (1989) viewed the role of directors as falling into three main roles which includes: service, strategy and control. Looking at it from the agency theory perspective, the presence of board of directors will enhance company performance by reducing agency cost (Al Mamun, Yasser & Rahman, 2013) that could result from diversification of a business. The ability of the board to discharge its role effectively may be hampered if the board is not structured properly, if there is domination of the board by CEO or there is problem with composition. The board of directors is an important monitoring mechanism in monitoring activities of managers (Zahra & Pearce 1989) especially in finance firms due to the complexity in the operations of those firms.

The management designs measures to manage risks and ensure proper implementation of those measures especially in diversified firms due to the increased risk in such firms (Andres & Vallelado, 2008). The outside directors on the other hand will provide monitoring over the activities of management and those measures put to safeguard the firm against risk (Ezzamel & Watson, 2005). Unlike non-finance companies, high risk taking by management in finance companies could lead to several failures (Tao & Hutchinson, 2013) and the cost of failure could be great to the entire economy (Pathon, 2009). The failure of an important or dominant company in the finance sector will lead to a ‘contraction’ in the finance sector ultimately leading to the failure of other companies in the sector similar to what happened during the financial crisis (Gordon, 2010; Gordon & Muller, 2010).

### 3. Hypotheses Development

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Board composition may be influenced by the strategy a firm adapts since the change in the environment of a firm may increase the competition and therefore the need to devise other ways to remain competitive. Therefore, board composition may need to be changed to reflect the change in the strategy of the firm by including directors from different background who will link the firm with the resources it needs to remain competitive (Hillman, et al., 2000). Furthermore, the composition of board of directors of a firm from resources dependence theory perspective is determined by the changes in the external environment. Therefore, the more dynamic the business environment in which a firm operates is, the higher the number of directors that needs to be appointed to the board and the more diverse the board of directors (Hillman, et al., 2000).

In addition, outside directors may be more important and needed by firms in regulated industry such as finance industry especially directors with appropriate experience. According to Pfeffer (1972) the composition of the board of directors of a firm is influenced by the extent to which a firm is dependent on the external environment for certain resources implying that firms that are highly dependent on the external environment for certain resources may need more outside directors that could serve as a link between the firm and the resources. He added that board composition is influenced by the response of organization to external environmental conditions. Independent directors serve as an important mechanism for the reduction of agency problem and the protection of minority shareholders (Ghazali, 2010). In diversified financial institutions with complex operations and sophisticated products (Stiroh, 2004), the presence of independent directors on the board helps to ensure the monitoring of management.

The importance of board chair independence depends on the strategic focus of company. Small companies that operate in one segment of the finance industry may benefit more from board with non-independent chair that will concentrate more on providing the necessary advice on the ways to enhance the performance and market potentials of the company while the effective monitoring service of independent chair will be more valuable to a finance company with complex assets and operations (Carcello, Hermason & Ye, 2011). Furthermore, the strategy of a finance company determines the extent of agency problem, risk, profitability and the ability of stakeholders to monitor its activities. Thus, performance of diversified financial institutions could be affected if the board is dominated by independent directors who may not have technical expertise to monitor the products and services of diversified finance companies such as investment banking services and trading in capital market which are fee based and very volatile (Stiroh, 2006). Minton, Taillard & Williamson (2011) found that independence of board reduces risk taking activities of insiders leading to a decrease in losses especially during financial crisis. Therefore, we posit that independent directors will likely support traditional strategy instead of diversified strategy that may increase the risk in firms and likely affect performance. The following relationship was hypothesized;

*H1 There is a positive relationship between board composition and diversification strategy of a finance company.*

*H2 There is a positive relationship between independent board chair and diversification strategy of a finance company.*

From resources dependent theory perspective a firm could enhance its competitive advantage by appointing directors with superior knowledge of the industry and regulation governing the industry so that they will be able to advise managers to take decision that will give the firm competitive advantage (Hillman, 2005). According to (Hillman, Cannella & Paetzold, 2000) having expert directors on the board reduces uncertainty and transaction cost associated with regulatory

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agencies. Directors with executive experience bring expertise and experience to the board as a result of their experience about internal firm operations and decision making in other firms (Hillman et al., 2000). In addition, their experience will enable them to bring a different view point on issues and provide information about how other firms dealt with certain problems. The external directors may provide advice and serve as a means of evaluating management proposals as strategies are being formulated (Hillman et al., 2000).

The effectiveness of board members in discharging their functions depends on their level of expertise in accounting and finance (Raber, 2003). Directors with accounting expertise and finance industry related experience would be in a better position to monitor the financial accounting and reporting activities in complex organizations like finance company (Tao & Hutchinson, 2013). Although expertise enhances the effectiveness of directors, the effect may vary with the company's strategy and lifecycle stage. In addition, industry expertise of directors may be more beneficial to a small and non-diversified small company in its early stage of development since the directors could serve as a resource to the management, while an established and diversified company at the declining stage of its development and with dispersed shareholdings may benefit more from directors with accounting and finance expertise who will concentrate on monitoring the company (Carcello et al. 2011).

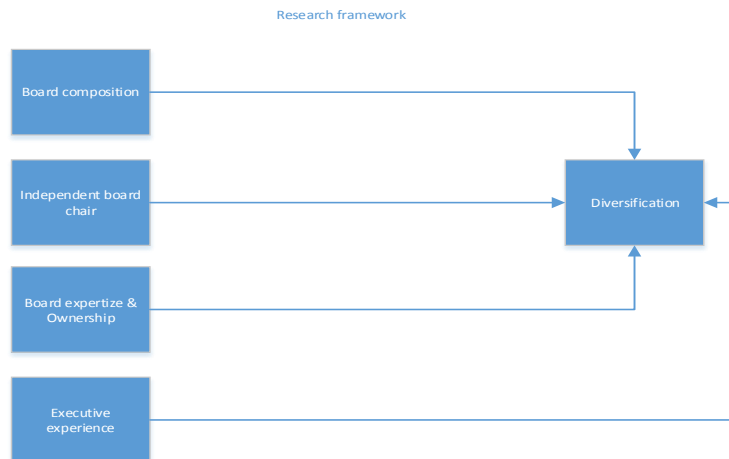
Minton et al. (2011) found that banks with more expert independent directors had poor performance compared to those with less expert directors. This could be explained by familiarity and understanding of the expert independent directors about sophisticated financial instruments which made them to allow management to take excessive risks. This could imply that firms with more expert directors took more risk by diversifying into risky businesses. Therefore, the following relationship was hypothesized;

*H3 There is a positive relationship between board expertise and diversification strategy of finance companies.*

*H4 There is a positive relationship between board composed of directors with executive experience and diversification strategy of finance companies.*

Ownership structure determines the extent of monitoring of the company's affairs because concentrated ownership which is common in developing countries could enhance performance (Haniffa & Hudaib, 2006; Mokhtar et al., 2009) and help reduce agency problem by aligning the interest of the shareholders, management and other stakeholders such as directors, institutional shareholders and government through ownership (Jensen & Meckling, 1976). Studies have shown that concentrated ownership which is a common form of ownership in developing countries is associated with better accounting performance in Malaysian companies (Haniffa & Hudaib, 2006; Mokhtar et al., 2009). The agency problem is expected to be minimal when the interest of the directors and the other shareholders is aligned through ownership of stake in the company by the directors. This will ensure that the strategy taken by management will promote the interest of all the shareholders and is in line with the acceptable risk level for all stakeholders. The risk appetite and the need for more profit by the controlling shareholders may influence firm's strategy. Therefore, the following relationship was hypothesized;

*H5 There is a positive relationship between director ownership and diversification strategy of finance companies.*



#### 4. Research Methodology

The sample comprised all finance companies listed on the finance sector of the main market of Bursa Malaysia as at the end of year 2011, which consist of companies spread across the various segments of the finance sector.

The study used secondary data that was collected from the annual report of the companies available from the website of Bursa Malaysia or the company’s website. In addition to the annual reports, financial information about the companies was obtained from Bloomberg data source. The annual report was used to obtain information on corporate governance mechanisms while information on the dependent variable and the control variables was obtained from financial information available from Bloomberg database.

Multiple regression analysis was used to test the relationship between the dependent and independent variables and analyze the data.

The study tests the following research model:

$$DIV = \alpha + \beta_1 CC_{it} + \beta_2 CINED_{it} + \beta_3 FE_{it} + \beta_4 EE_{it} + \beta_5 OWN_{it} + \beta_6 SIZE_{it} + \beta_7 LEV_{it} + \beta_8 ROA_{it} + YD + \varepsilon_{it}$$

The variables of the model are proxied as follows:

- DIV* = The ratio of non-interest income to total operating income
- CC* = Proportion of independent directors to total directors on the board
- CINED*= Dummy variable of one if chair is independent director zero otherwise
- FE* = Proportion of directors with accounting qualification on the board
- EE* = Proportion of directors with executive experience
- OWN* = Proportion of share ownership by directors
- SIZE* = Log of total assets
- LEV*= Total debt divided by equity
- ROA*= Return on assets

Furthermore, in order to reduce the possibility of endogeneity from omitted variable bias, we included a number of variables that could influence the adaption of diversification strategy by a firm (Chenhall & Moers, 2007). Control variables such as firm size, leverage and previous firm performance were used as control variable since evidence has shown that past performance affect the extent of board



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monitoring and advice to the management (Pugliese et al., 2014). Although there are roles prescribed by the regulatory requirements for the board of directors, the roles board gives more attention to depends on the circumstances of the company. Past performance of a firm affects the level of directors' involvement in providing advice to the firm. Directors are less involved in advising management on the appropriate strategic choice to make when a firm is performing very well while in poorly performing firms directors actively engage in monitoring and advise functions (Pugliese et al., 2014). In other words, board do not pay attention to their work when firm performance is good which could make the CEO to have more powers over the board and could make the board less active in performing its monitoring functions. From another perspective, past performance may imply less attention on financial control and monitoring activities and more attention on strategy by the board since high performance may mean the firm needs to find new investment opportunities in order to expand and become more productive (Hillman, 2005). In order words in profitable firms, board place more emphasis on new strategic direction and opportunities thereby reducing monitoring function (Lynall, Golden & Hillman, 2003).

Size was identified as a control variable and proxied as log of total assets in the research model similar to other prior studies (Pathan, 2009; Praptiningsih, 2009; Tao & Hutchinson, 2013) to account for the impact of resources on the diversification of a company. The size of a finance company will influence its ability to diversify its sources of revenue and at the same time prevent a significant change in its revenue in case of poor performance of particular business segment (Sufian 2010). On the other hand, the diversification of finance company will increase its risks as well as losses. In addition to size, leverage was also used as a control variable and was proxied by total debt divided by equity.

## 5. Results and Discussions

### 5.1. Results of descriptive statistics

The results of descriptive statistics presented in Table one indicates that the variables are normally distributed as depicted by the skewness and kurtosis values which are between  $\pm 3.00$  and  $\pm 10.00$  respectively. In addition to the test of normality for individual variables, normality for the group indicates that the data is normally distributed.

**Table 1.** Results of descriptive statistics

	DIV	CC	CINED	FE	EE	OWN	FS	LEV	ROA
Mean	0.339	0.481	0.260	0.312	0.353	0.030	0.042	0.064	0.025
Median	0.000	0.500	0.000	0.300	0.333	0.001	0.036	0.037	0.015
Maximum	1.000	0.777	1.000	0.857	0.800	0.240	0.088	0.310	0.079
Minimum	0.000	0.000	0.000	0.00	0.00	0.000	0.025	0.025	0.002
Std. Dev.	0.474	0.111	0.440	0.166	0.214	0.059	0.012	0.062	0.019
Skewness	0.678	-0.458	1.090	0.393	0.140	2.106	0.738	1.420	1.253
Kurtosis	1.460	4.451	2.190	3.273	2.129	6.144	2.704	5.204	3.265
Obs.	165	142	142	185	185	142	165	165	185

**Notes:** div=diversification, CC=independent directors, CINED=independent board chair, FE=finance expertise, EE=executive experience, OWN=direct director ownership, FS=firm size, LEV=leverage, ROA=return on assets.

Heteroskedasticity problem was identified and dealt with using the white's heteroskedasticity-consistent standard error while autocorrelation was addressed using white diagonal method. The result of correlation analysis presented in Table two indicates no multicollinearity problem in the model since none of the bivariate correlation is greater than 0.7.

**Table 2.**Results of correlation analysis

	ROA	DIV	CC	CINED	FE	EE	OWN	FS	LEV
DIV	1.000	1.000	0.009	-0.126	-0.155	0.021	0.198	-0.478	-0.135
CC	-0.074	0.009	1.000	0.076	0.372	0.050	0.042	0.062	0.151
CINED	-0.074	-0.126	0.076	1.000	0.224	-0.020	-0.244	0.237	-0.087
FE	-0.189	-0.155	0.372	0.224	1.000	-0.197	-0.046	0.100	0.181
EE	0.034	0.021	0.050	-0.020	-0.197	1.000	0.044	0.127	0.203
OWN	-0.170	0.198	0.042	-0.244	-0.046	0.044	1.000	-0.091	-0.167
FS	-0.148	-0.478	0.062	0.237	0.100	0.127	-0.091	1.000	0.281
LEV	0.112	-0.135	0.151	-0.087	0.181	0.203	-0.167	0.281	1.000
ROA	1.000	-0.074	-0.074	-0.189	0.034	-0.170	-0.148	0.112	-0.407

**Notes:**div=diversification strategy, CC=independent directors, CINED=independent board chair, FE=finance expertise, EE=executive experience, OWN=director ownership, FS=firm size, LEV=leverage.

### 5.2. Multivariate regression analyses

The result of Hausman's test indicates that random effect method is the best specification method to use. The adjusted  $R^2$  obtained was 0.2846 indicating that the variables collectively explain 28% of the variation in the dependent variable. The f-statistics (f- 4.6476) was large and the corresponding p-value ( $p < 0.001$ ) was highly significant or lower than the alpha of 0.05. Therefore the null hypothesis that the coefficients of the explanatory variables are jointly equal to zero can be rejected confirming that the data fits the research model of the study. Hypothesis three predicted a significant relationship between directors' expertise and diversification strategy. The result shows a significant negative relationship ( $p < 0.1$ ) between expertise of directors and diversification strategy.

This implies a company with expertise directors on the board is unlikely to diversify its activities as a result of the complexity and extra risk associated with the diversification strategy. The result is also contrary to Hillman (2005) and Hillman et al., (2000) who argued that expert directors provide advice to firms on strategies and serve as a means of information to the board on how other firms operate and dealt with certain problems. In addition this could be because the directors will provide the firm with other opinions. In addition, the result implies that directors with expertise and experience in finance industry will likely ensure that the company adopts traditional strategy by discouraging the management from diversifying the company in order to reduce the risk associated with diversification (Stiroh & Rumble, 2006) and in order to reduce their monitoring over those new businesses the firm will diversify into.

Companies could use directors with expertise to enhance their competitive advantage by providing expert advice to the company especially in relation to technical areas which requires expert knowledge to deal with.

The result also indicates that firm size is negatively related with diversification strategy. This is contrary to Sufian (2010) who argued that large companies diversify their activities as a result of the availability of more resources to the big companies which will enable them to diversify into other businesses. The result also indicates that firm performance is negatively associated with diversification. This is contrary to Hillman (2005) who suggests that high performing firms tend to diversify their activities as a result of the available resources from their profit which they need to invest in new business in order to expand and become more profitable. The remaining hypotheses tested were not significant.

**Table 3.** Results of regression analysis

	Pooled OLS	REM	FEM
Constant	0.4256(2.4656)***	0.3449(1.7818)***	0.4495(1.7744)*
CC	0.1442(0.4265)	0.5061(1.2283)	0.3443(0.5585)
CINED	0.0973(0.8412)	0.2132(1.3627)	0.4446(1.6225)
FE	-0.4162(-1.5768)	-0.5987(-1.7760)*	-0.9161(-1.8951)*
EE	-0.0266(-0.1340)	-0.2050(-0.7643)	-0.7550(-1.8143)*
DDO	0.9147(1.6205)	0.6811(0.9473)	-0.5035(-0.4873)
Firm size	-62.8006(-5.9614)***	-65.70322(-6.3884)***	-62.2698(-5.3253)***
LEV	0.8966(0.9031)	1.7216(1.3918)	7.0140(2.8082)***
ROA	-73.960(-1.2003)	-86.4885(-1.6730)*	-79.379(-1.4856)
Year dummies	0.0654(0.5160)	0.0362(0.3541)	0.0055(0.0527)
Year dummies	0.0922(0.7214)	0.0639(0.6137)	0.0341(0.3123)
Year dummies	0.2316(1.8072)*	0.1932(1.8311)*	0.1835(1.6170)
year dummies	0.9172(1.5037)	1.0191(1.9998)**	0.9496(1.8179)*
R <sup>2</sup>	0.3637	0.3626	0.6898
Adjusted R <sup>2</sup>	0.2858	0.2846	0.5510
F-statistics	4.6695***	4.6476***	4.9712***
Durbin-Watson	0.8678	1.2807	1.7833
Hausman's Test	NA	9.2004	NA

**Notes:** OLS= ordinary least squares, REM=random effect method, FEM=fixed effect method, CC=independent directors, CINED=independent board chair, FE=finance expertise, EE=executive experience, DDO=director ownership, LEV=leverage, ROA= return on assets.

## 6. Further Analysis

To assess the sensibility of the result to alternative form of analysis and in order to control for possible problem of endogeneity, we performed additional test using generalized method of moments (GMM). In addition to estimation based on least squares, the model was re-estimated based on the generalized method of moment model and the result as presented in Table four indicates some cases of sensitivities in the coefficient of some variables. The coefficient of board composition and ownership have become statistically significant but remained in the same direction while executive experience has become positive but remained in the same direction.

Except for these cases of sensitivities, the direction and statistical significance of all the remaining variables remained unchanged both in direction and statistical significance confirming that the result presented earlier based on the OLS model is robust to any potential problem of endogeneity. The sensitivity noticed could be as a result of the fact that corporate governance mechanisms may take time before their effect is felt. Furthermore, the sensitivity could be explained by the reduction in the period of observation from five to four years and finally, omission error in the model could also account for the sensitivities reported. The result of j-statistics indicates that the instruments used are valid.

**Table 4.** Estimation based on generalized method of moments model

	Estimation based on OLS model	Estimation based on GMM model
Constant	0.3449(1.7818)***	0.2813(1.761)*
CC	0.5061(1.2283)	0.2069(0.7315)***
CINED	0.2132(1.3627)	0.0466(0.5771)
FE	-0.5987(-1.7760)*	-0.4229(-1.912)**
EE	-0.2050(-0.7643)	0.0717(0.449)
OWN	0.6811(0.9473)	1.2040(2.322)**
Firm size	-65.70322(-6.3884)***	-50.23(-6.567)***
Leverage	1.7216(1.3918)	0.2977(0.4980)
ROA	-86.4885(-1.6730)*	0.2316(1.8072)*
Year dummies	-86.4885(-1.6730)*	-
Year dummies	0.0362(0.3541)	0.1317(1.559)
Year dummies	0.0639(0.6137)	0.1786(2.099)**
year dummies	0.1932(1.8311)*	0.1468(1.722)*
R <sup>2</sup>	1.0191(1.9998)**	-
Adjusted R <sup>2</sup>	0.3626	-
F-statistics	0.2846	-
Durbin-Watson	4.6476***	-

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Hausman's Test	1.2807	-
J-statistics	9.2004	0.3590(0.5490)

**Notes:** CC=independent directors, CINED=independent board chair, FE=finance expertise, EE=executive experience, OWN=direct director ownership, OLS=ordinary least squares, GMM=generalized method of moments.

### 7. Conclusion

This study examined the attributes of board of directors and ownership structure variables that are associated with diversification strategy of finance companies. Major corporate failure and financial crisis have been associated with board monitoring ineffectiveness. Therefore, understanding board attributes that are suitable for a particular company and how those attributes influence diversification strategy is necessary. Prior studies focused on investigating the impact of diversification on the performance of companies in the West with few studies focusing on developing countries. This study enhances the current literature by examining the impact of board attributes and ownership structure on diversification strategy of finance companies in Malaysia.

The result from the study suggests that expertise of directors is negatively related with diversification strategy. This indicates that firms with expert directors on the board are likely to remain focused in their traditional business. The result of estimation based on generalized method of moments suggests that the result is robust to possible endogeneity problem. The study has provided an insight into the board attributes which influence diversification strategy of a finance company and aid directors in structuring the board in line with their strategic focus. It provides policy makers with a better understanding of the various characteristics a board should have based on the strategic focus of the finance company and ultimately setting the appropriate level of regulatory requirements.

The study is limited to finance companies listed on the main market of Bursa Malaysia and based on five year (2007-2011) observation period. Future studies could increase the sample size and look at other sectors of the economy and period of observation. Qualitative approach could also provide direct information from those involved in making strategic decisions in companies. The study is based on data from one country, although there are similarities in corporate governance mechanisms among countries, the results could be influenced by the context of the study.

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