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Ownership structure, corporate governance and corporate performance in Malaysia

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Abstract

Purpose – Following the 1997 Asian financial crisis, the Malaysian Government introduced new regulations on corporate governance, recognizing the importance of restoring market confidence. The purpose of this paper is to evaluate the impact of the implementation of these new regulations on corporate performance.

Design/methodology/approach – Regression analysis was performed to examine factors influencing corporate performance. Ownership structure was represented by director ownership, foreign ownership and government ownership, and corporate governance was proxied by board size and independence. Corporate performance was measured by Tobin's *Q*.

Findings – Using data from the year 2001 annual reports of 87 non-financial listed companies included in the composite index, the results showed that none of the corporate governance variables was statistically significant in explaining corporate performance. Nonetheless, two ownership variables, namely the government as a substantial shareholder and foreign ownership, were statistically significantly associated with Tobin's *Q*.

Research limitations/implications – The regulations on corporate governance were implemented in 2001, perhaps it was too early to analyze results for the financial year 2001 as regulatory changes may take a few years before it could be expected to show positive or intended results.

Practical implications – An implication of this finding is that regulatory efforts initiated after the 1997 financial crisis to enhance corporate transparency and accountability did not appear to result in better corporate performance.

Originality/value – This is one of the few studies which investigates the impact of regulatory actions on corporate governance on corporate performance immediately after its implementation.

Keywords Corporate governance, Business performance, Corporate ownership, Malaysia

Paper type Research paper

Introduction

This paper examines the impact of corporate governance on corporate performance in Malaysia. It is based on the expectation that the issuance of the Malaysian Code on Corporate Governance (MCCG, 1999) might increase corporate awareness on good governance. Consequently, as the ultimate objective of corporate governance is to realize long-term shareholder value, it may be expected that companies which adopt best practices in corporate governance will perform better than others. In Malaysia, the focus on corporate governance heightened after the economic turmoil in 1997. In 1998, the Minister of Finance announced the establishment of a high level finance committee to look into establishing a framework for corporate governance and setting best practices for the industry. The Malaysian Government believed that improving and enhancing corporate governance would greatly assist in restoring confidence in the Malaysian market. In 2000,

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the MCCG was issued to the public. Part 1 of the Code sets out broad principles of good corporate governance in Malaysia while Part 2 sets out guidelines intended to assist companies in designing their approach to corporate governance. Among the recommendations in Part 2 are clear separation between the roles of chairman and chief executive officer (CEO), and that board membership should comprise at least two or one-third (whichever is higher) independent non-executive directors.

Compliance with the Code at that time was not mandatory, but the revised Bursa Malaysia (then Kuala Lumpur Stock Exchange (KLSE)) Listing Requirements now required disclosure of the extent of compliance with the Code in the annual reports. The revised Listing Requirements, announced in January 2001, required listed companies with financial years ending after 30 June 2001 to disclose in their annual reports the Statement of Corporate Governance stating how they applied the principles set out in Part 1 of the Code and the extent to which they complied with the best practices set out in Part 2 of the Code (KLSE, 2001, paragraph 15.26). Listed companies were also to ensure that their board of directors comprised at least two or one-third (whichever is the higher) independent non-executives by 31 July 2001 (KLSE, 2001, paragraph 3.14).

The importance placed on corporate governance in Malaysian companies is also evidenced in the two surveys jointly conducted by Bursa Malaysia and PricewaterhouseCoopers Malaysia. The first survey, which was carried out in 1998, basically examined board structure, the state of corporate governance, state of internal control, state of investor communication, structure and organization of Audit and Remuneration Committee and perceptions on Malaysia's corporate governance proposed reform (KLSE/PwC, 1998). About 94 percent of the respondents perceived reforms were necessary to restore and maintain investors' interest and confidence in the equity market. The 2002 survey attempted to gage perceptions among key stakeholder groups on Malaysian corporate governance standards. It also reviewed corporate governance practices in Malaysia since the issuance of the Code in 2000 (KLSE/PwC, 2002). Over 80 percent of the respondents agreed that Malaysia's corporate governance practices have improved since the 1998 survey. It was also reported that 69 percent of public listed companies surveyed had more than the minimum requirement of two or one-third of independent directors on the board.

The contribution of this paper is in weighing the innovative corporate governance efforts by regulators against traditional traits in the Malaysian business environment. The Malaysian business environment is characterized by family-owned and government-owned companies. Of the 238 Malaysian companies surveyed in Claessens *et al.* (2000), 67.2 percent were in family hands and 13.4 percent were owned by the government. Prior research on corporate governance has documented the significance of independent directors (Adams and Hossain, 1998; Eng and Mak, 2003) and chair independence (Haniffa and Cooke, 2002) in influencing the extent of voluntary disclosure. However, research on the relationship between corporate governance and corporate performance reported mixed results. This has led to questions about whether the principles of best practices in corporate governance which originated from developed countries are applicable in other countries. The business environments in the USA and UK are characterized by widely held companies (La Porta *et al.*, 1999) while owner managed and state controlled companies are the common features of developing economies (Claessens *et al.*, 2000). Thus, while separating the roles of chairman and CEO may be an efficient governance mechanism in developed countries, it may not be

so for developing economies if owners are deeply involved in the day to day operations of the business and hence most informed about their companies than others. It has been suggested that agency problems between principals and agents may be less prevalent in smaller and closely held companies (Eisenberg *et al.*, 1998; Maury, 2006).

The objective of this paper is to assess the relative influence of ownership structure and regulatory efforts on corporate governance implemented in 2001 on corporate performance. As corporate governance involves managing the business and affairs of a company towards enhancing business prosperity and corporate accountability, it may be expected that companies which adopt the recommendations of the Code perform better than others. The research question of this study is as follows:

RQ. Do companies which adopt the recommendations of the Code perform better than others?

The remainder of the paper is organized as follows. The next section discusses relevant literature to develop the research hypotheses. It is then followed by the research method outlining the sample selection and data collection procedure. Findings and analysis are provided in the ensuing section. Finally, conclusions and suggestions for future research are offered in the last section.

Development of hypotheses

Ownership structure

Ownership is represented by director ownership, foreign ownership, and government ownership.

Director ownership. Jensen and Meckling (1976) suggest that managerial ownership can help alleviate agency conflicts between managers and owners. That is because a manager who owns a large portion of the company shares has more incentives to maximize job performance to ensure better company performance. Empirical evidence regarding the relationship between director ownership and corporate performance is, however, mixed. While Agrawal and Knoeber (1996) and Daily and Dalton (2004) found results consistent with agency prediction, Chiang (2005) found that director shareholding was statistically significant but negatively related to corporate performance. Han and Suk (1998) documented that increase in director ownership led to better corporate performance, however, excessive insider ownership resulted in worse corporate performance, suggesting a managerial entrenchment effect. Elsewhere, Han *et al.* (1999), Himmelberg *et al.* (1999) and Chin *et al.* (2004) only found weak relationships between director ownership and corporate performance. In the Malaysian context, Mak and Kusnadi (2005), who examined the impact of corporate governance mechanisms on corporate values using data from 1999 and 2000, found that there was no significant relationship between insider ownership and corporate valuation. With the implementation of the Code in 2001, directors are expected to be more aware of their responsibilities to ensure long-term survival of their companies. A positive association between director ownership and corporate performance is hypothesized:

H1. There is a positive association between director ownership and corporate performance.

Foreign ownership. If a large portion of shares of a corporation is being held by foreign shareholders, it may signal that foreign shareholders have confidence in

those companies. This in turn may lead to a higher valuation of the company. Bai *et al.* (2004) reported that issuing shares to foreign investors has positive effects on market valuation. Prior studies also documented that companies with a higher proportion of foreign shareholders disclosed significantly more information in their annual reports (Haniffa and Cooke, 2002). Disclosing more information was believed could attract more investors (local and foreign). It is thus hypothesized that companies with a higher proportion of foreign shareholders perform better than others:

H2. There is a positive association between foreign ownership and corporate performance.

Government ownership. Government ownership is another common feature of the Malaysian business environment. The government's involvement in the business sector is particularly evident in privatized entities. One of the specific aims of the privatization project was to restructure and ensure a more equitable society. As of December 2000, privatized entities constituted 5 percent of listed companies, however they contributed 30.3 percent to total market capitalization. Government ownership in privatized entities as of that date was 49.5 percent. Given the importance of privatized entities, it may be expected that the government would closely monitor and oversee the activities of these companies. The government would ensure continued success of these companies so that the objectives of privatization are met. Thus, it may be expected that government-owned companies would perform better than others. Empirical evidence on the association between government ownership and corporate performance is, however, mixed. Hovey *et al.* (2003) documented evidence that state ownership in China did not have explanatory power on corporate performance. However, Bai *et al.* (2004) found that when the largest shareholder was the government, market valuation was significantly lower implying that state interference may result in bad performance. On the other hand, Ang and Ding (2006) reported that government-linked companies had higher market valuation than non-government linked companies in Singapore. Given the special nature of government-owned companies and constant monitoring by the government, a positive association between government ownership and corporate performance is expected:

H3. There is a positive association between government ownership and corporate performance.

Corporate governance

Corporate governance is represented by board size, independent directors and chair independence.

Board size. The resource dependence theory suggests that larger board size would lead to better corporate performance because of the different skills, knowledge, and expertise brought into boardroom discussion. However, Dehaene *et al.* (2001) and Chin *et al.* (2004) did not find a significant association between board size and corporate performance. Proponents of the board size effect argue that larger board size may lead to problems in group coordination and effectiveness in arriving at decisions (Jensen, 1993). This view is supported by Conyon and Peck (1998) who found negative relationship between board size and corporate performance across a number of European countries. Additionally, Eisenberg *et al.* (1998) also documented significant negative correlation between board size and profitability in a sample of small Finnish corporations. Yermack (1996) reported an inverse relationship between board size and market valuation in US companies.

Consistent with the findings of prior studies, Mak and Kusnadi's (2005) analysis of Malaysian and Singaporean corporates using data from 1999 and 2000 also found evidence to support the board size effect argument. As the majority of prior studies appears to suggest a negative relationship between board size and corporate performance, it is hypothesized that companies with smaller board size perform better than others:

H4. There is a negative association between board size and corporate performance

Independent directors. Agency conflicts are expected to be higher in widely held companies due to divergence of interest among contracting parties (Jensen and Meckling, 1976). One such conflict may arise between inside owner-managers and outside minority shareholders. Fama and Jensen (1983) argue that the existence of independent directors would result in a more effective monitoring of the board and limit managerial opportunism. That is because independent directors are supposed to look after the interests of outside minority shareholders. Thus, to reduce agency conflicts, independent directors can be appointed to the board. Following this line of argument, if independent directors succeed in discharging their monitoring role and ensuring that the board makes decision in the best interests of all shareholders, opportunistic behavior could be avoided, hence company performance should improve. Empirical results appear to show that independent directors are statistically not strongly associated with corporate performance (Coles *et al.*, 2001; Chin *et al.*, 2004).The proportion of independent directors was also found to have little impact on corporate performance in Hong Kong (Chen *et al.*, 2005). In contrast, Dehaene *et al.* (2001) found independent directors to be significant and positively influencing performance in Belgian companies. In the Malaysian context, Chang Aik Leng (2004) who studied Malaysian companies for the period 1996-1999 did not document significant association between independent directors and corporate performance. The present study examines whether the introduction of the Code in 2001 has a positive impact on corporate performance. It is expected that with the introduction of the Code, independent directors will be more aware of their responsibilities and would discharge those responsibilities more effectively. It is hypothesized that the higher the proportion of independent directors on the board the better will be the corporate performance:

H5. There is a positive association between the proportion of independent directors on the board and corporate performance.

Chairman. The Code recommends that the chairman and CEO positions be held by two different persons to ensure a balance of power and authority. The role of the independent chairman is important to ensure decisions of the board reflect the views of the majority and not that of a dominant personality. The argument against role duality stems from the notion that directors are entrusted with monitoring and evaluating the actions of top management, combining the roles would mean evaluating own performance (Rhoades *et al.*, 2001). Based on this argument, separating the roles of chairman and CEO should lead to better corporate decisions and hence performance. Empirical evidence on the relationship between role duality and corporate performance is mixed. Brickley *et al.* (1997) did not find unitary leadership structure to be associated with inferior accounting and market returns. Bai *et al.* (2004) reported that for companies in which the CEO was also the chairman or vice chairman of the board of directors, market valuation for these companies were significantly lower. A negative relationship

between CEO duality and corporate performance was also documented in Hong Kong (Chen *et al.*, 2005). In contrast, role duality (functions of chairman and CEO are combined) was found to be significant and positively associated with corporate performance in Belgian companies when measured by return on assets (Dehaene *et al.*, 2001). In the Malaysian context, two conflicting results were documented in prior research. While Chang Aik Leng and Abu Mansor (2005) found role duality to be significant and positively associated with corporate performance, Rahman and Haniffa (2005) reported the opposite. Both studies were using data pre-2001. It is expected that with the implementation of the Code which recommends separation of roles, companies in which the CEO is an independent director performs better than otherwise:

H6. There is a positive association between chair independence and corporate performance.

Control variables

Two control variables are included in the analysis namely, company size and competitiveness. Larger companies are expected to be more profitable due to economies of scale, ability to obtain cheaper sources of funds and greater diversification (Chang Aik Leng, 2004) and hence would be more able to spread their business risks. More competitive companies are expected to be more profitable given that they normally capture a larger portion of the market share.

Research method

The data for this study were collected from the 2001 company annual reports. The annual reports were downloaded from the Bursa Malaysia web site. The year 2001 was chosen to see whether the introduction of the Code in 2000 and Bursa Malaysia Listing Requirements regarding corporate governance made compulsory in 2001 have an impact on corporate performance. In addition, the KLSE/PwC (2002) survey on corporate governance found that corporate governance practices have improved since 1998. Thus, it is worthwhile to see if the improvement in corporate governance practice was associated with better corporate performance.

Companies chosen for analysis were those included in the composite index. Companies included in the composite index are generally actively traded and large in size. Given their high volume of trade, it is thus appropriate to assume that these are the companies that more readily attract the interest of investors. Consequently, it may be expected that these companies would apply good corporate governance practices. With the exception of 13 finance[1] companies, all other 87 companies in the composite index were included in the analysis.

Findings and analysis

Descriptive statistics

Table I shows descriptive statistics of all independent variables. Panel (a) of Table I shows that director ownership in the companies investigated was as high as 71.71 percent with a mean of 21.42 percent. This is expected given the business environment in Malaysia which is essentially built upon family businesses[2]. The statistics regarding foreign ownership which shows percentage holding between 13.0 and 80.16 percent suggests that all companies in the analysis had some foreign involvement. This supports the argument that these are the companies that

Panel a: continuous variables				
Independent variables	Label	Min	Max	Mean
Director ownership (%)	DirOwn	0	71.71	21.42
Foreign ownership (%)	ForOwn	0.13	80.16	23.83
Board size	Bsize	4	14	8.83
Company size (RM)	Cosize	172,496	54,584,800	3,794,138
Competitiveness (%)	Comp	0.23	89.34	12.99
Panel b: categorical variables				
Government shareholding	GovtSub	1 = the government is a substantial shareholder	0 = the government is not a substantial shareholder	
Number		56 (64 %)	31 (36 %)	
Independent directors	IndNED	1 = independent directors ≥ 1/3 of the board	0 = independent directors < 1/3 of the board	
Number		61 (70 %)	26 (30 %)	
Chairman	ChairInd	1 = chairman is an independent director	0 = chairman is a non-independent director	
Number		22 (25 %)	65 (75 %)	

Table I.
Descriptive statistics of independent variables

foreign investors are more interested in, hence the relevance of their inclusion in the analysis. Corporate board size ranges between 4 and 14 with an average of 8.83. This average size is slightly higher than Mak and Kusnadi's (2005) analysis on Malaysian companies of 7.5. The slightly higher average documented in the present study could be partially due to the focus of current study on large companies[3].

Panel (b) of Table I shows that 64 percent of the sample companies have the government as a substantial shareholder. This is not surprising because prior research has shown that Malaysia is one of the countries where state control is a normal phenomenon (Claessens *et al.*, 2000). However, the statistics in respect of independent directors is quite alarming considering about 30 percent of sample companies did not have independent directors constituting one-third of the board members. This means that the listing requirement regarding independent directors was not met by some sample companies investigated. Additionally 75 percent of companies analyzed had chairmen who were not independent directors. This observation is not unexpected especially when companies are closely held or family controlled.

To determine the association between ownership structure, corporate governance, company characteristics, and corporate performance, a multiple regression analysis employing eight independent variables was carried out.

The regression model is as follows:

$$\text{Tobin's } Q = \beta_0 + \beta_1\text{DirOwn} + \beta_2\text{ForOwn} + \beta_3\text{GovtSub} + \beta_4\text{IndNED} + \beta_5\text{ChairInd} + \beta_6\text{Bsize} + \beta_7\text{CoSize} + \beta_8\text{Comp} + \varepsilon$$

Table II shows operationalization of all variables included in the analysis.

Table III shows the results of the regression analysis. It can be seen from Table III that the regression model which incorporates eight independent variables results in an adjusted R^2 of 39.6 percent[4]. This means that the eight variables tested were able to explain 39.6 percent of the variation in profitability among Malaysian listed

Variable	Definition
Tobin's Q	Corporate performance measured by year-end value of market capitalization/book value of total assets
$\beta_0 \ldots \beta_8$	Regression coefficients
DirOwn	Proportion of shares held by executive and non-independent directors
ForOwn	Proportion of shares held by foreign shareholders
GovtSub	1 if the government is a substantial shareholder in the company; 0 otherwise[a]
IndNED	Independent non-executive directors measured by 1 if independent directors are at least 1/3 of the board, 0 otherwise
ChairInd	Chairman, 1 if chairman is an independent director, 0 otherwise
Bsize	Number of directors on the board
CoSize	Company size measured by total assets
Comp	Competitiveness measured by ratio of the sample company's sales to the total sales of the companies in the same industry sector
ε	Error term

Notes: With the exception of market capitalization, foreign shareholding and competitiveness, all other data were taken from company annual reports. Data on market capitalization and industry competitiveness were obtained from Datastream, foreign shareholding from *Investors' Digest* July 2002. [a]Tests of collinearity and multicollinearity were carried out before the regression analysis. Pearson correlation results show that none of the independent variables were correlated more than 0.5. VIF as shown in Table III are less than 10.0 indicating multicollinearity was not a problem in interpreting the results of the analysis

Table II.
Variables included in the regression analysis

Adjusted R^2	39.6				
F-statistics	7.568				
Significance	0.000				
Variables					
Constant	β	t-*value*	*Significance*	*Tolerance*	*VIF*
		−0.279	0.781		
DirOwn	−0.073	−0.762	0.449	0.825	1.213
ForOwn	0.367	3.397	0.001**	0.645	1.550
GovtSub	0.197	1.988	0.051*	0.771	1.297
IndNED	0.001	0.007	0.994	0.812	1.231
ChairInd	0.014	0.139	0.890	0.713	1.402
Bsize	0.055	0.600	0.551	0.885	1.129
CoSize	−0.454	−3.744	0.000**	0.513	1.949
Comp	0.632	5.325	0.000**	0.536	1.866

Note: Coefficients are shown as significant at: *10 or **1 percent level

Table III.
Standard multiple regression results

companies investigated in this study. Two ownership variables, namely foreign ownership and the government as substantial shareholders were statistically significant and positively associated with corporate performance. However, none of the corporate governance variables were statistically significant in explaining corporate performance. This implies that regulatory efforts initiated after the 1997 economic crisis did not result in better corporate performance. Foreign ownership was statistically significant at the 1 percent level. Consistent with expectation, companies with a larger proportion of foreign ownership were found to be more profitable. Government ownership was

statistically significant at the 10 percent level. As hypothesized, companies in which the government was a substantial shareholder, performed better than others. The two control variables included in the analysis were also statistically significant at the 1 percent level. However, contrary to expectation, larger companies were found to be less profitable perhaps due to problems in coordinating the different functions or line of businesses. As expected, companies with a greater proportion of market share performed better possibly indicating their success in attracting more customers and providing goods and services which are of quality and value.

Conclusions and suggestions for future research

This paper has examined the impact of corporate governance on corporate performance. The results showed weak evidence to indicate that companies which adopted good governance practices performed better than others. None of the corporate governance variables were statistically significant in explaining corporate performance. This finding could be partially due to the time period under examination. The regulations on corporate governance were implemented in 2001; perhaps it was too early to analyze results for the financial year 2001 as regulatory changes may take a few years before they can be expected to show positive or intended results. Nonetheless, one may still question the relevance and effectiveness of the Code as even though the regulations came about in 2001, the market knew about the efforts long before the introduction, as evidenced in the 1998 survey. A possible explanation for this finding could be that perhaps the Code which is based on the Hampel Report in the UK is not suitable in the Malaysian context due to different political and cultural factors affecting business environment. Another possible factor influencing corporate governance effectiveness could be the legal environment of a country. Malaysia has a low litigious environment as opposed to the USA and UK where shareholder protection is very good (La Porta *et al.*, 1999). That may have some bearing on incentives to comply with regulatory requirements.

Future research on corporate governance and corporate performance could consider the above factors when planning their research design. Analyzing data which are not too close to the year of implementation of corporate governance guidelines may provide better insight into the impact of corporate governance on corporate performance. Additionally, a different methodology such as interviewing market participants can be undertaken to gather industry views on issues related to corporate governance. Interviews may shed some light on the effectiveness of board independence. Findings from the interviews could provide fruitful suggestions on how best to design a corporate governance regime for each/different business setting(s) to ensure realization of long-term stakeholders' value.

Notes

1. These companies were excluded from the sample due to different regulatory requirements and materially different types of operations.
2. Claessens *et al.* (2000) show that at the 20 percent cut-off level, 67.2 percent of Malaysian public listed companies were in family hands.
3. Mak and Kusnadi (2005) sample selection of 230 listed companies was based on availability of annual reports. Financial companies were also excluded from the analysis.
4. Tests of collinearity and multicollinearity were carried out before the regression analysis. Pearson correlation results show that none of the independent variables were correlated

more than 0.5. VIF as shown in Table III are less than 10.0 indicating multicollinearity was not a problem in interpreting the results of the analysis.

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