CHAPTER 2: LITERATURE REVIEW

2.1 Background
In Malaysia, the aim towards achieving good corporate governance standards began before 1997. As a move to a disclosure based system for regulating the capital markets, Securities Commission of Malaysia stressed on strengthening corporate governance standards among Malaysian public listed companies.

In 1998, the Finance Committee on Corporate Governance was commissioned by the Malaysian government to provide a comprehensive report on measures to improve corporate governance of public listed companies within the country. This led to the publication of the Report on Corporate Governance in February 1999.

The definition of corporate governance as proposed by the Finance Committee on Corporate Governance in the Report on Corporate Governance is as follows: "Corporate governance is the process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realising long term shareholder value, whilst taking account the interests of other stakeholders".

2.2 Good versus Weak Corporate Governance
Business prosperity and accountability are of great importance in contributing towards good corporate governance. According to the Hampel Report (January
there was no single formula to combine people, teamwork, leadership, enterprise, experience and skill to produce prosperity and it is dangerous to stipulated rules and regulations to do so.

Good corporate governance, however, does not solely refer to good business practice. It is the most powerful system within an organisation in ensuring effectiveness, efficiency and reliability of financial and internal reporting, and minimising exposure to risks (Jelantiaranat, 1999). Weak corporate governance can thus be is a result of weak internal control. Internal control is a system targeted at achieving predetermined objectives such as profitability, stability and growth of each organisation.

The Cadbury Committee saw governance as a means of promoting more efficient markets. It was concerned not just with the harm that poor governance could harm an organisation, but also ways in which the board members could contribute to the success of an organisation. Cadbury might have over-emphasised the monitoring role of corporate governance at the expense of the organisation's future (The Hampel Code, 1998).

Five common practices that cause weak internal control, and hence weak corporate governance have been identified by Jelantiaranat (1999) as follows:

1. Boards members, Chief Executive Officer (CEO) and senior management fail to emphasise the importance of a strong system of internal control.
(2) There is no linkage established between the criteria used to determine compensation and promotion, and compliance with the internal control system.

(3) CEO and senior management fails to define the organisation structure and managerial accountability.

(4) Senior management has poor understanding of activities in the organisation and how those activities generate profits for the organisation.

(5) Failure of management to manage changes derived from globalisation.

In a Seminar on Corporate Governance, 1999, Abdul Aziz Mohd Yaacob, stated that weak corporate governance could be attributable to the following factors:

(1) Ownership concentration, where many companies with large shareholders exercise rights at the expense of expropriating those of the minority shareholders.

(2) Control rights by the largest shareholder are often disproportionately greater than the actual ownership holdings.

(3) Foreign fund managers and domestic institutional investors choose to play a passive role in striving for better corporate governance practices in Malaysian public listed companies.

(4) Mechanisms for ensuring compliance and enforcement are generally deficient, as penalties are insufficient.
Owners are not aware and do not fully understand considerable complex common law and statutory responsibilities.

It can be inferred from the two articles above (Jelantiaranat, 1999 and Abdul Aziz Mohd Yaacob, 1999) that good corporate governance is probably not attainable due to the complacency of board members, the CEO and senior management in an organisation. Simpson (1998) indicated that the Hampel Report was issued at the end of a decade-long bull market, and governance was bound to become an important issue when signs of the bear market began. Lee (1996), in the local scenario, identified that most shareholders and company regulators were the least interested in issues pertaining to good corporate governance during boom times of economic growth. Awareness of corporate governance obviously heightens when the stock market crashes, and large corporations suffer huge losses. It was also during these times, dishonest or self-serving directors exploit the situation to benefit themselves at the expense of their organisations.

2.3 Corporate Governance Variables

The Pensions Investment Research Consultants Limited (PIRC) analysed companies' governance profile according to board balance (size), board function and board policy. Saldana (1999), on the other hand, used governance factors such as ownership type, firm size, corporate control structure and industry sectors to analyse the companies. Governance variables such as firm size and
industry sectors were also used by Xu and Wang (1997) to analyse the governance profiles of organisations. Classens, Djankov and Pohl (1996) also classified organisations by industry sector for their analysis. In general, different countries have different guidelines governing organisations. Hence it is rather difficult to identify standard governance variables to be used in a research. Xu and Wang (1997) even used state-owned organisations as one of their variables, but this may not be suitable for the corporate culture in Malaysia because state-owned organisations such as Perbadanan Kemajuan Negeri Selangor (PKNS) and Syarikat Perumahan Pegawai Kerajaan (SPPK) are not publicly listed companies.

Firm size can be defined according to total assets of an organisation or net sales generated by an organisation. Xu and Wang (1997) defined the firm size according to the book value of a company's total assets, while Saldana (1999) used net sales. It would be rather difficult to use net sales to define firm size due to the differences in the structure of financial and non-financial sectors in the market. Financial sectors report the turnover of their companies rather than net sales. Saldana (1999) did not emphasise on financial institutions, but rather, looked at non-financial institutions, which probably explains why firm size in the study was based on net sales.

Ownership structure is seen to have significant effects on performance of stock companies (Xu and Wang, 1997). Besides that, they also found that institutional
shareholders appear to have played a positive role in corporate governance. This is consistent with the theory expounded by Shleifer and Vishny (1986). They developed a model to demonstrate that a certain degree of ownership concentration is desired in order for the market to work more effectively. Ownership concentration refers to percentage of the top five shareholders within the organisation.

2.4 Corporate Governance, Investment and Financing Patterns

Corporate governance mechanisms assure investors in organisations that they will receive adequate returns in their investments (Shleifer and Vishny, 1997). If these mechanisms did not function properly, external investors would not lend to such firms or purchase their equity securities. That being the case, firms will thus be forced to rely entirely on internally generated cash flows and financial resources to finance ongoing operations as well as profitable investment opportunities.

Where an organisation relies on external finance, an appropriate corporate governance system may lead to an agency problem (Thillainathan, 1999). This is due to the need for a separation between management and finance, or between ownership and control. In the case of locally-controlled companies, the concentration of shareholding imposes a severe constraint on corporate control.
Regardless of the separation between ownership and control as documented by Berle and Means (1933), as cited by Glen, Lee and Singh (2000), as well as by Renneboog (1998), the competitive selection process in the product markets would ensure that managers are responsible for profit maximisation. Based on that observation, owners of the firm were seen to delegate responsibilities to management. This would lead to a situation of “strong managers, weak owners” (Renneboog, 1998). However, this observation could not be generalised in all situations, but only under strict assumptions of perfect competition and no barriers to entry.

Shleifer and Vishny (1997) suggest that even though there is greater and more intense competition, there will still be an agency problem in large corporations with the separation of ownership and control. Thus, the knowledge of corporate ownership patterns in developed and developing countries could help to unravel the nature of the agency problem in organisations (Rajan and Zingales, 1998).

"Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment" (Shleifer and Vishny, 1997). In order to achieve this objective, they suggest that the central issue of corporate governance is therefore "How do suppliers of finance control managers?"
In deciding whether to rely on external or internal financing, economic analysis suggests that corporations in developing countries may be obliged to rely on internal financing for future growth prospects (Glen, Lee and Singh, 2000). It should be noted that corporations in developing countries are not free from asymmetric information. However, Singh (1995) found that external financing which comprises debt financing and equity financing would be used once internal financing reached a certain level. Emmons and Schmid (1999) identified three sources of internal or near-internal financing in “underdeveloped” capital markets. They are owner-contributed funds, retained earnings and bank debt.

To identify the degree of corporate financing, Saldana (1999) uses five variables i.e. self-financing ratio (fixed assets) and self-financing ratio (total assets) for internal financing, new equity financing ratio, incremental debt financing ratio and incremental equity financing ratio for external financing. From these variables, it was observed that companies financed fixed assets from internal sources during hard times due to a slow down in income generation. However, it could also be seen that the contribution to internal funds to finance growth has declined over the years.

Relying on equity financing in emerging markets is rather risky due to considerable share price volatility. This volatility therefore tends to discourage such corporations to raise funds via equity financing. Besides that, share price
volatility also reduces the efficiency of market signals (Glen, Lee and Singh, 2000).

The Kuala Lumpur Stock Exchange (KLSE) rulings and the Malaysian Companies Act 1965 play a vital role in the enforcement of corporate governance in Malaysia. As it was not properly monitored, it led to corporate governance irregularities. There has been evidence to show that share price movements are in fact related to corporate governance irregularities. An examination of share price movements with respect to an announcement of corporate governance irregularities in 1997 led to a decline in the share price of United Engineers Malaysia Berhad (UEM) and KFC Holdings Berhad (Thillainathan, 1999). Renneboog (1998), on the other hand, shows that a positive stock price reaction follows corporate restructurings, repurchases, downsizing, and therefore wealth creation opportunities exist.

Furthermore, Glen, Lee and Singh (2000) found that during the severe liquidity crisis in 1990, the Indian government greatly accelerated the process of liberalisation and economic reforms. With this, there was a vast expansion of share market activity and important steps were taken to improve the functioning of the markets in making them more transparent, and less subjected to insider trading and fraud. The main idea emphasised is that for the kind of changes that have occurred in a number of countries in corporate finance and share market activity, differences over time within the same country are more important than
differences between countries within the same time period and their existing basic legal systems.

2.5 Corporate Governance and Corporate Performance

Is there a link between good corporate governance and improved company performance? Do companies that pay attention to governance best practice outperform those that do not?

Simpson (1998) of PIRC sensed a need to prove that governance had a role to play in producing better performance. There is a consensus that good governance is preventive as it can make a corporate disaster less likely. Markets around the world also appear to indicate that governance can enhance performance.

According to Yavitz (1998), a board’s effect on corporate performance is mainly long term. However, when management gets into trouble, the actions of a board can have short term implications on performance. It was also found that a board which is too large and too loaded with insiders, as well as those directors who have conflicting interests, can affect performance.

In analysing the relationship between corporate governance and corporate performance, Saldana (1999) used five standard financial performance ratios i.e. leverage, return on equity (ROE), return on assets (ROA), total asset turnover
and net profit margin, with respect to ownership type and corporate control variables. From this, it was found that in spite of high net profit margins on sales, public listed companies in the Philippines performed poorly in terms of ROE. Besides that, public listed companies invested more in fixed capacities as indicated by lower fixed assets turnover and employed more equity to finance these assets. Here again, it should be emphasised on the importance of differences over time within the same country, as the ease of access to equity in the Philippines by the public listed sector was available during the stock market boom.

Emmons and Schmid (1999) used the ROA, which is an internationally comparable performance ratio. If investors prefer the highest possible return, then inefficient use of corporate assets becomes an indication that prevailing corporate governance system has not adequately aligned the interests of managers and owners adequately.

To justify the relationship between ownership concentration (a governance variable) and corporate performance, Xu and Wang (1997) suggested that institutional investors have the incentive as well as the power to monitor and control the behaviour of the management, and have played a significant role in corporate governance. These results are consistent with the findings of Classens, Djankov and Pohl (1996) who analysed the relationship between ownership concentration and corporate performance in the Czech Republic.
Rajan and Zingales (1998) hypothesised that firms in industries that require relatively large amounts of external finance to succeed will perform better in countries where financial markets are better developed. From this hypothesis, it can be implied also that corporate governance matters for corporate performance. They found that firms in industries that require large amounts of external financing grow faster in countries with better financial development. Better accounting standards, larger capital markets, stronger legal protections of investors and a stronger rule of law are all good predictors of growth by firms that need external finance (Emmons and Schmid, 1999).

2.6 Conclusion

Based on the views of these experts mentioned above, there seems to be a close link between corporate governance with corporate performance, investment as well as financing patterns.