CHAPTER 4: THEORETICAL FRAMEWORK AND HYPOTHESES DEVELOPMENT

4.0 Introduction

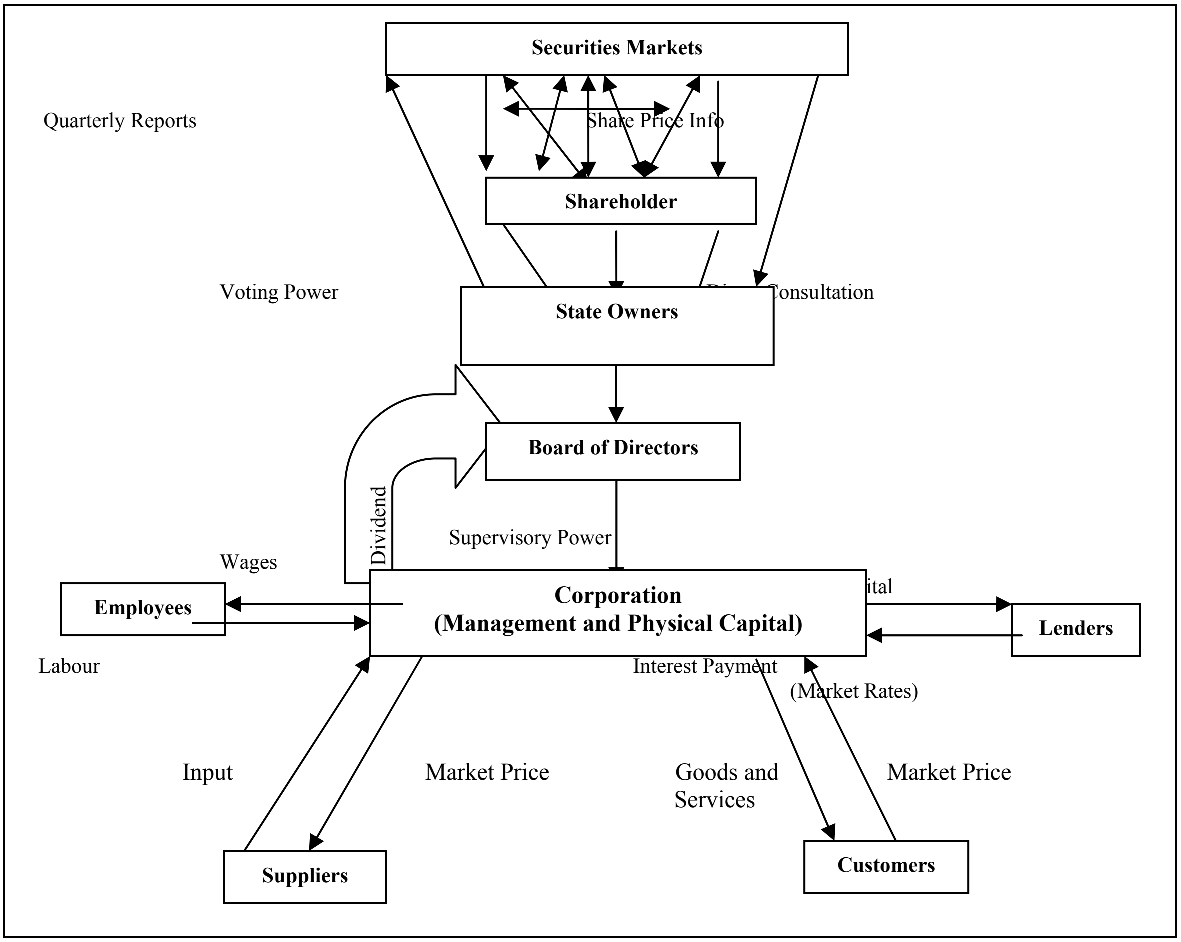
This chapter will discuss theories relating to company performance. The major theories applied in relation to company performance are specifically the theory of the firm and agency cost theory. In the theory of company, this study will elaborate on the model used in corporate governance, and the structure of ownership, especially in government or state owned corporations. This will be followed by a discussion of the agency theory. The agency problem is another factor in this research framework where there is a separation of control between the owner and manager.

4.1 Theory of the Firm

A discussion on the theory of the firm is important because of the different structures of ownership, especially when the government or state is involved. In this theory, one mechanism that needs to be elaborated upon is the corporate governance mechanism. The corporate governance mechanism can be viewed from the internal and external perspectives. The internal perspective often sees the boards of directors and equity ownership as the primary internal mechanism (Denis and McConnell, 2003; Cremers and Naim 2004). While from the external perspective, block ownership, institutional ownership and government ownership serve as the external monitoring substitute. The combination of the two mechanisms will constitute the corporate governance of a company. However, corporate governance, instead of being viewed via internal or external perspectives, may also be viewed according to its model, as highlighted by Bai, Song, and Zhang (2003). The market-based governance model or Anglo American model has the characteristics of an independent board, dispersed ownership, transparent disclosure, active takeover markets, and well-developed legal infrastructure. In comparison, the control model or Franco-Germany model emphasises the value of insider board, concentrated ownership structure, limited disclosure, and reliance on family finance and the banking system.

Diverse external ownership and its conflict with management has been the central theme of corporate governance literature for many years, dating back at least to Berle and Means (1932). The basic proposal is that the company's requirement for technological advancements and economies of scale has been the primary driving force in the quest for large capital pools. To facilitate such a requirement, companies issue shares that many diverse investors take up. The consequence is that the "owners" cannot effectively manage or control the company individually or jointly. As a result, the oversight and management, and, thus, the control of the company, is delegated to professional corporate management (see Figure 4.1).

Figure 4.1 Corporate Governance Model with State Owners



(Source: Adapted from Blair, 1995)

As illustrated in the Figure 4.1, the separation of ownership and control concentrates the control of the company in management. Primarily, this management control is in the hands of one person, the chief executive officer (CEO) (Denis & McConnell, 2003). The shareholders elect the directors to the board of directors, which has supervisory power over executive management. In the board of directors, the Government should have some but not all of the seats. This makes it possible to articulate government policies with business ones (in addition to controlling management), but leaves space for the company to make its own operational decisions. Other stakeholders, such as employees, lenders, suppliers and customers can only exert influence at an operational level and on management, as shown in the above model. Bhattacharyya (2005) indicated that some state-owned enterprises should not have merely commercial objectives because their mission is “to generate possibilities externalities”, e.g. in the case of energy, to ensure the region’s supply. The separation of owner (shareholder) from decision maker (manager) creates an agency problem between these two entities in the company due to the conflict of interest. Government owned companies or SOEs have same core problem in terms of separation of control and ownership in which the owner comprises the citizens of a country. Normally, SOEs cannot have their board changed via a takeover or proxy contest, and most cannot go bankrupt due to government or state intervention. The absence of potential takeovers and proxy contests reduces the incentives of the board members and managers to maximize company value, and the lack of bankruptcy can introduce a soft budget constraint, which reduces pressure to contain costs (Baygan-Robinett 2004; Estrin 1998).

4.1.1 Role of State Ownership

State ownership around the world was very common in many countries post-war. In their study of ownership around the world, La Porta et al. (1999) found that, globally, state ownership was second only to family ownership of large companies. Applying criteria whereby ownership of greater than 20% is considered to have effective control of the company, they found that in their sample of large traded companies in the richest countries globally, 18% of companies were state-controlled. They also found that widely held companies amounted to 36%, 30% were family-controlled, and the residual categories amounted to 15%.

Government ownership can be referred to as government linked companies (GLCs), state-owned enterprises (SOEs), government corporations (GC), parastatals, public enterprises, public enterprises, or public sector enterprises (OECD,2003). These ownerships remain in middle- and lower-income countries despite extensive privatisation over the last two decades. For emerging markets like Malaysia and others middle- and lower-income countries, state or government ownership remains significant despite extensive privatization over the last decades. The state or government in emerging countries owns and control major industries such as air and rail transport, utilities such as electricity, gas and water supply, broadcasting, telecommunications, and banking and insurance. Table 4.1 shows some examples of state or government ownership in emerging market economies.

Table 4.1: State or Government Ownership in Emerging Market Economies

Country	Market Economies
China	▪ In Mainland China, central government is responsible for the control of17,000 SOEs, meanwhile SOEs under local exceed 150,000companies. On the Shanghai and Shenzen stock exchange almost all listed companies are directly or indirectly state owned. ▪ OnHong Kong Stock Exchange Chinese, SOEs make up 35 percent of market capitalization in which about 1,200 listed SOEs produce more than 18 percent of GDP, and their total market capitalization is around 40 percent of GDP.
India	▪ Beside the financial sector, the government is responsible for 240 public sector enterprises, which produce95% of India's coal, 66 percent of its refined oil, 83 percent of its natural gas, 32 percent of its finished steel, 35 percent of its aluminium, and 27 percent of its nitrogenous fertilizer. ▪ India railways alone employ 1.6 million people, making it the world's largest commercial employer. ▪ Financial sector SOEs account for 75 percent of India's banking sector.
Indonesia	▪ The Ministry of State-owned enterprises controls 162 SOEs and has minority stakes in another 21. ▪ With $86 billion in assets and an estimated 1.4 million employees, over 70 percent of SOEs operate in competitive sectors, including pharmaceuticals, agriculture, fisheries and forestry; printing and publishing and over 20 other industries.
Malaysia	▪ There is a body led by Khazanah Holdings with six other GLICs controlling over 56 listed companies in Bursa Malaysia, which make up RM260 billion or approximately 36% and 54%, respectively, of the market capitalization of Bursa Malaysia and the benchmark Kuala Lumpur Composite Index. ▪ GLCs account for an estimated 5% of the national workforce. Even with active divestment and privatization, GLCs remain the main service providers to the nation in the strategic utilities and services including electricity, telecommunications, postal services, airlines, airport, public transport, water and sewerage, banking and financial services.
Poland	▪ There are approximately 1,800 SOEs accounting for about 28 percent of GDP and 30 percent of employment.
Russia	▪ Companies controlled by the federal government produce 20 percent of the country's industrial output, the regional governments another 5 percent. ▪ As measured by assets, the federal government controls 20 percent of the banking sector, the regional government 6 percent.
Singapore	▪ Temasek which is the national holding company has a $90 billion portfolio with shares over 20 major SOEs, including such well-known multinationals as SingTel, Singapore Airlines and Raffles. ▪ The 12 GLCs listed on the Singapore Stock Exchange represent about 20 percent of market capitalization and produce 12 percent of GDP.
South Africa	▪ There is about 270 SOEs with a total turnover in excess of $15 billion a year.
Vietnam	▪ 5,2000 SOEs produce 38 percent of GDP, contributing 22 percent of total government revenue through earnings and taxes.

(*Sources: OECD; China; Qiang (2003), Mako and Zhang (2004), The Economist (2003); Indonesia: Babcock (2003) and Ministry of State-Owned Enterprises (2002); Malaysia: The Putrajya High Performance on GLCs (2007), www.khazanah.com.my; Poland: Prus (2003); Singapore: Mako and Zhang (2004), www.temasekholding.com.sg*)

State ownership of companies is justified in that they are considered more efficient when concentrated ownership provides too few rents for stakeholders or when concentrated ownership is net optimal. Thus, the general argument is similar to that which pertains to cooperatives, but is often especially applied where there are concerns regarding matters such as monopoly power, externalities, or issues regarding distribution or social concerns (Bennett & Maw, 2003). Similar to cooperatives, stakeholders may realise appropriate outcomes because they have control over such areas as quality and the services provided (Hart, 2003), more so than if driven by a profit-maximising motive.

A principal problem of state ownership is based on the grabbing hand view of government ownership, in that heavy burdens may be imposed on the economy by public sector institutions (Shliefer & Vishny, 1998). Examples are SOEs that expend economic prosperity policies, law and taxes that impede investment, corruption, and the impact of the most talented people involved in unproductive pursuits (Shleifer & Vishny, 1998).

Bureaucrats have practically total power in state companies, and bid pursuits of any political purpose – either that of the ruling government or even their own, under certain circumstances (Duckett, 2001). Nonetheless, it is reasonable to assume that they have little regard for profit in as much as these profits flow into government budgets. Furthermore, bureaucrats have goals that are quite removed from social interest. However, as state companies, cash flow ownership is effectively dispersed amongst the taxpayers; they have no meaningful cash flow rights. Furthermore, typically the objectives of bureaucrats are determined by their political interests, which are very different from social welfare interests (Boycko et al., 1996; Shapiro & Wellig, 1990; Shleifer & Vishny, 1994). To illustrate, special interest groups, such as public employee trade unions that frequently resolutely support state ownership, often hold sway with bureaucrats (Lopez de Silanes, Shleifer, & Vishny, 1997). State ownership is, therefore, a typical case of consolidated control, no cash flow rights, and having objectives that may at times be socially detrimental. Considered from this standpoint, it is not at all unexpected to find that state companies are inefficient.

In the worldwide drive for greater efficiency, privatisation has become a common response in recent years (Megginson & Netter, 2001). It has been fuelled by growing awareness of the inefficiency and drain on treasuries of state companies (Yarrow, 1999). Privatisation usually replaces political control with private control (Becht, 1999). In most economies, it also forges concentrated private cash flow ownership as well as control. A substantial performance improvement is typically the result of a change of ownership structure to one that is relatively more efficient (Lopez de Silanes, 1997; Megginson, Nash, & van Randenborgh, 1994).

4.1.2 Government Ownership Monitoring and Motivating the Performance

One of the main goals of GLCs reform is better monitoring and motivating performance. The government needs to ensure arrangements to motivate GLCs or SOEs to high performance and measure this company's achievement with respect to the nonfinancial, policy objectives. For example in Singapore, Temasek expects those GLCs in which they hold shares to (i) be world class and compete internationally, in order to attract talent, (ii) have a high quality board, (iii) focus on core competencies, and (iv) pay competitive wages; and maximise financial performance in terms of EVA (economics value added), return on assets (ROA) and return on equity (ROE). GLCs performance may be benchmarked to international standards (Mako and Zhang, 2004).

SOEs also need to develop and evaluate commercial objectives such as careful development of strategic business plant, cash flow forecasts, and regular reporting, which are needed for the shareholder's representative to exercise effective governance and to link management or employee performance and incentive compensation.

In Malaysia, the government systematically instil a high performance culture within GLCs by making people in the companies more accountable for, and more rewarded by, company performance. By that, the importance of the right culture, values, attitudes and mindset for the nation, as well as the critical role of people in all spheres. In a knowledge-driven world, a company's human resources are the source of its competitive advantage. Consequently, the government has implemented Key Performance Indicators or (KPIs) in GLCs to enhance their value and performance as well as their financial performance (ROA, ROE) and market performance. Two pilot projects on KPI implementation have been running in Malaysian Airlines and Malaysia Airports, which are led by the Second Finance Minister. This steering committee will meet once a month to track progress and resolve any issues that may arise. Bonuses and stock options constitute management compensation for senior management if they achieve their targets in KPI (Putrajaya Committee on GLCs High Performance (PCG), 2008)

The exercise of the government ownership rights should be separated from regulation and other policy functions. A direct way to do this is to establish a single dedicated ownership entity, such as specialized ministry, agency, or holding company, for all SOEs or one for financial SOEs and one for nonfinancial SOEs. An alternative approach is to create a coordinating body that works with ownership entities, which, in turn, exercises the ownership function independently of other activities. A combination is also possible, with the central entity directly overseeing many but not all SOEs, and/or with SOEs migrating from ministry to central control over time. For example, the government established Khazanah as an agency to lead Malaysian GLICs and the PGC as a committee to monitor the performance of GLCs.

Government ownership also needs to adopt corporate governance policies. The mechanisms through which the ownership entity monitors and motivates the performance of SOEs and exercises the government ownership right should be clearly defined, transparent and not discriminate against other shareholders. This includes the nominations of board members, the oversight of both commercial and policy objectives, and the participation of the ownership entity in the general shareholders' meeting.

In summary, the government as one of the GLCs boards should be informed and active in: (i) formulating, monitoring and reviewing corporate strategy, within the framework of the overall objectives defined by the government and the ownership entity; (ii) ensuring key risk areas are identified and appropriate performance indicators are established; (iii) monitoring the disclosure and communication processes, ensuring that the financial statements fairly presents the affairs of GLCs or SOEs and reflect the risk incurred; and (iv) assessing and following management performance. GLCs boards should also ensure that an effective succession plan for all directors and key executives is in place.

4.2 Agency Theory

In principle, a company could be owned by someone who is not a patron. Such a company's capital needs would be met entirely by borrowing; its other factors of production would likewise be purchased on the market, and its products would be sold on the market. The owner(s) would simply have the right to control the company and to fitting its (positive or negative) residual earnings. Ownership commonly is hiring persons who have some other transactional relationship with the company. This is because the ownership relationship can be used to mitigate some of the costs that would otherwise attend these transactional relationships if they were managed through simple market contracting.

More particularly, market contracting can be especially costly in the presence of those conditions loosely called "market failure", such as market power or asymmetric information. In such circumstances, the total costs of transacting can sometimes be reduced by merging the purchasing and the selling party in an ownership relationship, hence, eliminating the conflict of interest between buyer and seller that underlies or aggravates many of the avoidable costs of market contracting.

In this section, the agency theory will be reviewed in the context of its impact upon corporate governance. Overall, although the range of economies on which studies with regard to finance theory have been carried out is quite limited, it has been increasing in the last decade. Literature that is more recent stems from other Anglo-US countries and from Europe and East Asia. Consequently, much of the focus of corporate governance research is centred on these countries.

The consequence of the separation of ownership and control in the modern corporation, as argued by Berle and Means (1932), is the potential for conflict between the owner and professional manager. Management objectives may be at variance from those of the shareholders of the company. Shareholdings in a sizeable corporation may be so widely held that they find it challenging to have their objectives heeded or to influence management that may well exploit the situation and serve their own interests more readily than that of the shareholders.

Ross's (1973) "principal-agent" or agency problem, as is commonly known, has at its core the separation of ownership and control, or, as aptly put by Shleifer and Vishny (1997), of "management and finance". The crux of the problem is that funds are raised from investments in worthwhile projects, or alternatively, from the cash out of the holdings of the entrepreneur or manager in the company. The relationship is built around the manager's need for the investors' funds and the investors' need for specialised professional human capital of the manager. The original intent of this statement originated from the fact there is interdependency between principal agent's need, partly because management need external funding management requirement to investment activities, similarly, the principal can utilize large holdings of cash by hiring a professional manager to manage the funds available to the principal.

Jensen and Meckling (1978) describe agency costs as the sum of the costs of structuring contracts whether formal or informal, monitoring expenditure by the principal, bonding expenditure by the agent, and the residual loss. The residual loss is the opportunity cost associated with the change in real activities that occurs because it does not pay to enforce all contracts perfectly. They argue that the parties to the contracts make rational forecasts of the activities to be accomplished, and allow structured contracts to facilitate those activities. At the time the contracts are negotiated, the actions motivated by the incentives established through the contracts are anticipated and reflected in the contracts' prices and terms. Hence, the agency costs of any relationship are born by the parties to the contracting relationship. This means that some individuals can always benefit by devising more effective ways of reducing the costs. Jensen and Meckling use the agency framework to analyse the resolution of conflicts of interest between stockholders, managers, and bondholders of the company.

In general, the problem with corporate governance can be traced to the relationship between an agent and its principal. The agent is usually the management of the company, mainly the CEO of the corporation. Principals can be in the form of various parties like the shareholders, creditors, suppliers, clients and employees. Boards of directors, audit committees, and external auditors usually act as intermediaries or representatives for agent and principals.

Jensen & Meckling (1976) and Fama & Jensen (1983) are among the first that identified the problems of the agent being responsible to the principal. There is an assumption that managers will act opportunistically to take care of their own interests before those of the shareholders. They defined agency costs as being the sum of the costs of monitoring management, bonding the agent to the principal and residual losses. Their analysis also showed, among others, why accounting reports are provided voluntarily, why auditors are employed by the company and why monitoring by security analysts can be useful. This separation of corporate managers from outside stakeholders results in inherent conflict and there is a need for some sort of corporate governance mechanisms by which managers can be disciplined to act in the best interests of the stakeholders.

In relation to agency cost in SOEs or GLCs, the agency view shares with the social theory the idea that governments seek to maximize social welfare. The agency view explains that public managers have less than private managers due to a lack of incentives when controlling SOEs. The agency view predicts that, in general, state-owned enterprises serve social objectives and allocate resources where the private market fails. However, public managers of SOEs may exert little effort or divert resources for personal benefits, for example, career concern, with an eye towards future job prospects in the private sector.

There are two main agency relationships within exchange-listed corporations (Ali, Chen and Radhakrishnan, 2007), which are Type I and Type II. According to them, Type I agency relationships concern shareholders and management whereas Type II agency relationships involve majority and minority shareholders. In every situation, every conflict between the two parties can lead to costs that reduce the value of the company. However, there is a different nature with the involvement of state or government ownership because management and government have politically motivated objectives.

There are several reasons why managers in state-owned company may be less motivated to maximize shareholders wealth. Government shareholders mostly have a political agenda as their main objective compared to value-maximization. In addition, government shareholders are unlikely to have a specialized knowledge of a firm's operation, allowing some scope in pursuing their personal objectives. Executive turnover and bonuses also tend to be less in firms with state shareholding (Boycko, Shielfer and Vishny, 1996; and Dewenter and Malatesta, 2001). Collectively, these characteristics can impose a significant cost to corporations with any form of state ownership.

There are also positive aspects concerning government ownership. It has been argued that where the manager has less monitoring and control in the company, the agency cost associated with managerial entrenchment will also depend upon the external labour market (Jensen and Meckling, 1976). There is also minimum competition from other potential managers due to the limit to the cost of obtaining managerial services. For state-controlled enterprises, the senior manager is often appointed through a political process as managerial entrenchment is high; the relationship between managers and government shareholders will naturally have a long-term focus, and this will mitigate the myopic behaviour of management.

Study has found that companies with a concentrated ownership structure usually have a conflict between controlling and non-controlling shareholders because controlling shareholders have the power to ensure that managers pursue objectives at the cost of minority shareholders. For example, controlling shareholders may vote sympathetic directors on to the board or make their company engage in related party transactions. Research has shown that agency costs resulting from controlling can be significant (Shielfer and Vishny, 1997). In the case of state enterprises, the controlling shareholder is the state, conflicts occur because the government's objective concerns social welfare whereas the company's objective is profit maximization. Bos (1991) shows that in the situation when a competitive environment is not perfectly competitive, the government has an incentive to monitor managers and act as internal regulator.

4.2.1 Managing the Agency Problem

In this section, managing the agency problem and its associated costs is discussed. The separation of ownership and control leads to managers finding themselves with considerable discretionary control over the funds that shareholders invest. The problem is that their agent, managers, do not always act in the shareholders' best interests and may engage in opportunistic behaviour. A most important point for consideration and discussion is how to minimise the agency problem and the associated costs.

A primary concern then is how to overcome, or at any rate, minimise these agency costs and reduce both managerial perfunctoriness and unresponsiveness to shareholder interests. For example Mason (1960, p83) wrote, "the search is directed toward ways of limiting or governing power that may be used against the interest of others while keeping as much as possible of the ability to act in (the manager's) own or his organisation's interest". Gilson and Roe (1993, p874) observed that the "analysis of American corporate governance has always sought to solve the problem of separation of ownership and control". The corporate governance structure is intended to be a means to address the matter of agency costs. However, in itself, it does not solve the problem completely and some corporate governance structures work better than others do.

4.2.2 Incentive Contracts

One of the potential solutions for reducing agency conflict or problems is incentive contracts, which are common practice in many parts of the world (Choi, 2001; Earle & Sapatoru, 1994; Earle Sapatoru, 1996; Hemmer, 1993). Shleifer and Vishny (1997, p744). The reason being that the objective of incentive contracts is to accord the manager "a highly contingent, long term incentive contract ex ante to align his/her interests with those of investor". The intent behind the use of incentive contracts is to encourage management to discharge its duty with a focus on the best interests of investors, but without instigating blackmail in any form.

Management in large companies own too little equity for it to be a catalyst for profit maximisation, or for it to induce any specific managerial focus (Berle and Means, 1932). Incentive contracts provide a possible answer and come in a wide range of shapes and structures, such as equity ownership, equity options, or deterrence of the threat of termination after poor performance (Fama, 1980; Jensen & Meckling, 1976). Ultimately, the significance of the manager's decisions, the individual risk aversion characteristics, and the capacity to pay outright for cash flow ownership, determine the optimal incentive contract (Holmstrom, 1979; Holmstrom, 1982; Mirrlees, 1976; Ross, 1973; Stiglitz, 1975). A performance measure is highly correlated with the manager's decision quality, and must be justifiable to make the incentive contract more feasible and convincing to the principal.

A positive relationship connecting pay and performance has been found by several studies, which thus rejected the extreme hypothesis of complete separation of ownership and control, and in so doing takes issue with Berle and Means (Benston, 1985; Coughlan & Schmidt, 1985; Murphy, 1985). Nonetheless, a study of US executives' pay to performance sensitivity by Jensen and Murphy (1990) considered salary and bonuses, equity options and the effects on pay of potential dismissal on pay if earnings are at a low level. It found that a relatively high number of executive remunerations in the US both rise and fall by approximately US$3 per US$1,000 change in shareholders wealth. The conclusion that Jensen and Murphy arrived at is that this is an indication of efficient compensation arrangements and that politically motivated restrictions on very high executives remuneration packages is the driving force. Studies spanning the US, Germany, and Japan by Kaplan (1994a; 1994b) found that the pay to performance and dismissal sensitivity is similar in the three countries. Jensen and Murphy's findings of the sensitivity of pay to performance may require considerable risk tolerance by executives as it may produce huge fluctuations in executive wealth. Haubrich (1994) concluded that further sensitivity may perhaps be inefficient for risk-averse executives.

However, findings in relation to incentive contracts indicate that they do not fully overcome the agency problem, due to various associated complications. First, managers are exposed to greater company specific risks as exposure to the company increases and optimal diversification decreases, and thus they require compensation for that risk (Meulbroek, 2001b, 2001a). Furthermore, there are a number of ways in which managers can maximise their own utility and behave opportunistically in incentive contracts (Garvey, Grant, & Kig, 1998; Noe, 1999; Shapira, 2000). In addition, as the holdings of management increase, the literature suggests that it affects the behaviour of management. An increase in the holdings in any one company reduces a manager's diversification and potentially increases the risk and management required returns.

For example, a clear negative link is found between derivative holdings and management risk-taking incentives (Roger, 2002) and is inversely associated to the use of leverage (Harvey & Shrieves, 2001; Ryan & Wiggins, 2001). It is also shown to impact upon company's acquisition and divestiture propensity (Aggarwal & Samwick, 2003; Avery, Chvalier, & Schaefer, 1998; Sanders, 2001).

The results of a study by Yermack (1997) implied that equity options are often used as a clandestine self-dealing mechanism, rather than the intended incentive instrument. He observed that managers received allocations of equity options just prior to positive news announcements and wait until after negative announcements to receive allocations. Also implied is that self-dealing opportunities are a problem, particularly if the negotiation of contracts takes place with boards of directors that are poorly motivated, as opposed to negotiating with large investors. Favourable contracts can be negotiated when managers know that there is likely to be an increase in earnings or a rise in stock prices. Alternately, increased earnings can be sought by manipulating investment policy and/or accounting figures favourably.

An influential role in restraining the sensitivity of executive earnings to performance has almost certainly been played by legal and political factors found in the US. This also seems to be common in other countries (Jensen & Murphy, 1990; Shleifer & Vishny, 1988).

Considering the opportunities for self-dealing in ambiguous and acquisitive incentive contracts, regulators and courts have viewed them with certain misgivings. In the US, the business judgment rule prevents the courts from getting involved in corporate decisions, except in the matters of executive pay and self-dealing (Shleifer & Vishny, 1997). Since the remuneration of the shareholder manager is generally related to the size of companies, rather than performance, they engage in self-interest empire building, rather than wealth maximisation.

Thus, in conclusion, as promising as incentive contracts may appear, they do not fully overcome the agency problem, due to the obstacles and drawbacks associated with them. There are a number of ways in which managers can maximise their own utility and behaviour opportunistically, which negate the extent of benefits brought about by the agent principal relationship.

4.2.3 Legal Protection

Investors provide external financing principally because they receive certain control rights, in relation to the assets of the company, in exchange for their investment. Essentially, external financing is a contract between the company and the financiers, whose rights are enforceable by the legal system. The rights are influenced by the legal system and are not intrinsic to the securities per se (La Porta et al., 1998). Throughout the world, corporate governance systems differ primarily in the managerial legal obligations to financiers, and in how these are interpreted and enforced by the courts (Shleifer & Vishny, 1997). In the eighteenth and nineteenth centuries, much of the development of corporate law in Britain, Continental Europe, and Russia focused specifically on dealing with the problem of larceny by management, rather than on avoidance or even empire building. The legal system in numerous countries endeavours to protect investors from managerial diversion of company assets to themselves (Hunt, 1936; Owen, 1991).

Generally, legal systems around the world have a tendency to offer investors a somewhat restricted collection of rights (La Porta et al., 1999). Shareholders' legal rights may include areas such as voting on important corporate matters like mergers, acquisitions and liquidations, and the election of directors who, in turn, have certain rights with regard to the management (Easterbook & Fischel, 1983; Manne, 1965). Common-law countries have a propensity for considerably greater investor protection, for both shareholders and creditors, than do many civil-law countries (La Porta et al., 1998). In addition, investor protection and enforcement is generally weaker in poorer countries (La Porta et al., 1998). For civil-law countries, La Porta et al. (1998) found that the French-civil-law tradition is the weakest, whereas the German-civil-law and the Scandinavian countries give greater protection. Thus, the literature finds significant variations between countries with civil-law systems. It is also asserted that minority investor protection is too weak in certain other countries in Europe –Italy is cited as an example (Bianchi, Bianco, & Enriques, 1997).

Shareholder voting rights happen to be costly to exercise and enforce. Postal voting by shareholders is not permitted in many countries (La Porta et al., 1999), and the cost of attendance at such meetings almost certainly ensures that small investors do not vote. Voting rights are violated quite transparently in countries with weaker legal systems (Shleifer & Vishny, 1997). Essentially, courts in developed countries can be depended on to make certain that voting does take place (Shleifer & Vishny, 1997). However, management still interfere by various means in the process of voting (Grundfest, 1990; Pound, 1988). Shareholder resolutions are a mechanism for disciplining management, but they are so uncommon that they have little effect. For example, in the six years from 1984 to 1990, only 0.35% of boards encountered a proxy challenge, of these only 28% were completely successful (Grundfest, 1993).

It is quite common for managers to be required to adhere to a duty of loyalty to shareholders, which augments shareholder-voting rights and obligates managers to act in the shareholders' best interests. Albeit, some argue that managers should also have a duty of loyalty to their employees, creditors, community, the state and other stakeholders (Hopt & Teubner, 1985). In China for example, the law singles out directors' duty to act honestly in the interests of the company and not use their position to seek personal gain. In most developed countries, and especially in OECD countries, the courts generally accept the notion of the duty of loyalty by managers' to stockholders in principle, in that their investment is generally as a sunk cost – further investment by them will not generally be required –and thus the discipline that this brings does not apply.

Because of this, stockholders have less protection from expropriation, which thus necessitates the introduction of protection to encourage their initial investment. For example, in the case of self-dealing of managers, the law may prohibit or enforce corporate rules that forbid it (Easterbrook & Fischel, 1991). Restraints also stipulate that stockholders with minority holdings are treated no worse than insiders are (Holderness & Sheehan, 1988a). Managers' actions may also be restrained by legal constraints, for instance by providing stockholders the ability to monitor and to prevent assets being sold at reduced prices, or alternatively, by insisting that management confer with the board of directors before certain important decisions are made (Shleifer &

Vishny, 1997). Even though in most OECD countries, there is in principle acceptance of the duty of loyalty, court enforcement differs considerably (La Porta et al., 1999).

Law enforcement can be a substitute for weak legal rights or rules as courts may act to protect investors rights – "active and well-functioning courts can step in and rescue investors abused by the management" (La Porta et al., 1998, page 18). For instance, in the US, Japan, and Germany, the law at least does protect some of the rights of investors and is reasonably willing to enforce these laws. Generally, law enforcement (as distinct from legal rights) varies considerably throughout the world. Enforcement in the German-civil law and the Scandinavian system tend to be unsurpassed. It is also generally robust in common-law countries. French-civil-law countries tend to be the weakest. Law enforcement quality has the tendency to ameliorate considerably as income level rises (La Porta et al., 1999).

As an example of enforcement in the US, stockholders may bring a claim against the corporation if management is deemed to have violated the duty of loyalty. Thus, the free-rider problem is circumvented by the use of class action suits. Nevertheless, class action suits are prohibited generally outside the US and Canada (Romano, 1993). In the case of the US, courts will interpose if managers issued equity to themselves, or if management larceny and asset diversion was involved. Nevertheless, intervention is unlikely even if there should happen to be exorbitant pay hikes, particularly when it is in the form of complicated option contracts. Likewise, business decisions, even if they might be damaging to stockholders, are also not likely to be challenged by the courts. Overall, the US is considered reasonably liberal concerning the restrictions imposed by the duty of loyalty, andit is argued by some that it is not stringent enough (Bebchuk, 1985; Brudney & Chwerelstein, 1978).

Court enforcement differs considerably from country to country, however, in general, it functions the best in OECD countries. In most of the remaining countries, there is in principle, weaker acceptance of the duty of loyalty. La Porta et al. (1999) point out that, to some extent, this is because the capacity of the courts to interfere in business is limited. The result being that in many countries, investors cannot necessarily be assured they will get their money back through the legal protection offered. The situation can be quite serious in some developing countries, particularly in most non-OECD countries, where the legal systems do not operate as well and offer investors less protection. Typically, the legal obligations to financiers are not well protected or enforced.

Overall then, the legal system in OECD countries offers some protection to the rights of some investors at least. Essentially though, the legal system provides less protection for investors. The legal protections to make certain that the rights of investors are upheld and that their investment is protected are deficient.

4.3 Agency Cost Proxies

According to Ang, Cole and Lin (2000), Fama and Jensen (1983), and Jensen and Meckling (1976), it was assumed that owner-managed companies have either zero or significant agency costs. Usually, the owner-managed companies can be referred to as companies that are monitored by the government itself. Government staffs involved in GLCs are expected to be altruistic towards national priority and, hence, it is believed that altruism could mitigate some agency costs (Wu, 2001). Therefore, this study uses agency cost proxies among the independent variables influencing company performance. Generally, not many researchers directly connect the measurement issues of agency costs.

Agency theory suggests, promulgated by Fama and Jensen (1983) suggest that the splitting of CEO and board chair facilitates more effective monitoring and control of the CEO, hence non-duality may lead to better firm performance. Based on this suggestion, firms that fail to split such order (non-duality) may have dampening effect on firm performance for two reasons. Firstly, the absence of separation between ownership and control may hamper effective monition of management activities (Fama and Jensen, 1983).

Besides the role of non-duality as a proxy for agency costs, two alternate measurements of agency costs have been adopted by Ang and Ding (2005), Florackis and Ozkan (2004), Sign and Davidson III (2003) and Ang et al. (2000). The two alternative efficiency ratios that are regularly used in the literature of accounting and financial economics are the expense ratios and asset utilisation or asset turnover. In this study, only expense ratio is adopted because it directly relates to company performance that will lead to better or worse. According to Ang et al. (2005), their findings indicate that agency costs increase when the owner-manager's equity stake decreases. This result is similar to the theory of Jensen and Meckling (1976).

The expense ratio is measured by dividing operating expenses by annual sales. Expense ratio is positively related to agency cost, which indicates that high expense ratio experiences high agency cost. This expense ratio measures how effectively the management of the company controls operating costs such as expenses on hiring new executives, luxury automobiles or company furniture, and also other direct agency costs. Contraction of results is expected when this agency cost proxy is related to capital structures such as debt to asset ratios (Ang et al., 2000).

In summary, this section has discussed the theory of the firm from the external market-based viewpoint. First, we considered the view of the company presented by Berle and Means (1932) that a modern firm has widely dispersed, small shareholders, which cannot control the company themselves and rely on directors to watch over their interests, and on professional managers who are their agents to ensure they get the maximum possible return on their investment.

4.4 Research Hypotheses

Hypotheses for this study are derived based on documented evidence, and specific characteristics of GLCs and non-GLCs, to align with stated objectives. To supplement this study, three sets of hypotheses have been developed to determine whether differences exist in terms of performance. Performance is measured by the accounting-based measure of ROA and the market-based measure of Tobin Q after taking into account company specific factors such as the control measure. The hypotheses developed are as follows:

Hypothesis 1: Government Involvement Does Not Have Any Significant Impact on Company Performance in Malaysia and Singapore

Although there is no one reason that can be singled out that government involvement as a stakeholder of the company may make a big difference on company performance, documented evidence suggests that investors value good corporate governance (Felton et al., 1996), as government ownership functions as an institutional alternative to regulation. Certain literature (e.g. Shepherd, 1989; Laffont and Tirol, 1993; Hartt, Shleifer and Vishnu, 1996) suggests that governments are likely to pay special attention to political goals rather than the profit driven motive, hence, government ownership might lead to poorer performance. Nonetheless, government owned companies may have greater advantages in terms of credit, liquidity and cost of capital. As a result, government involvement might provide greater incentive to perform better.

The testable sub-hypotheses of the study have been developed as follows:

$H_0 1_a$: GLCs exhibit no different in Tobin's Q compared to non-GLCs

$H_0 1_b$: GLCs exhibit no different in stock return compared to non-GLCs

$H_0 1_c$: GLCs exhibit no different in return on assets (ROA) compared to non-GLCs

$H_0 1_d$: GLCs exhibit no different in return on equity (ROE) compared to non-GLCs

Hypothesis 2: GLCs Perform Better Than Non-GLCs in Terms of Comparing Company Specific Characteristics in Malaysia and Singapore

With government intervention and control of companies, better governance mechanisms are put in place to ensure better performance. The government is directly involved in businesses in which it has a monopolistic advantage due to the nature of the business operations. Examples are those that provide economic infrastructure and essential services, such as electricity, telecommunications, and airlines. The main purpose for which the government is involved in business is to promote economic growth and to contribute significant social well-being in the country. Government involvement in GLCs then helps to increase company value. Previous studies (Majumdar, 1996; Ang and Ding, 2005; Kirchmaer and Grant, 2005: Ab Razak, Ahmad and Aliahmed, 2008) generally find that with government intervention, some company characteristics such as size, non-duality role, leverage, agency costs have a significant relation with company performance. Therefore, this study suggests that based on company specific characteristics, GLCs have to perform better than non-GLCs.

The testable sub-hypotheses of the study have been developed as follows:

H_02_a : There is no difference in relationship between company size and company performance Between GLCs and non-GLCs

H_02_b : There is no difference in relationship between size and company performance between GLCs and non-GLCs

H_02_c : There is no difference in relationship between company growth and company performance between GLCs and non-GLCs

H_02_d : There is no difference in relationship between leverage and company performance between GLCs and non-GLCs

H_02_e : There is no difference in relationship between non-duality role and company performance between GLCs and non-GLCs

H_02_f : There is no difference in relationship between agency cost and company performance between GLCs and non-GLCs

Hypothesis 3: Malaysian GLCs Will Perform Better than Singaporean GLCs on Market and Financial Performance

The involvement of the Malaysian government through the NEP has led to different structures of company ownership. This was a result of the NEP implementation to achieve the national goal of at least 30% Bumiputra equity stake through their involvement in company ownership structures of public listed companies. The government has been directly involved in Malaysian listed companies through Khazanah Holdings, six other government linked investment companies (GLICs), and the "golden share". The "golden share" implies minimal 'controlling' shares owned by the government, which means that despite not being the major shareholder, the government still maintains its control of the company. These companies are normally in industries in which the government has a monopoly, such as utilities (electricity), telecommunications, and airlines. Khazanah and the other six bodies led by politicians and civil servants try to provide maximum profit from their companies for the stakeholders, which are the government and the Malaysian citizens.

Across the causeway, however, the Singaporean government control over its companies has been relatively loose, due to the appointment of outsiders or foreigners to run these companies even though the government is the majority shareholder. These appointments could lead to the loss of not only control of the companies by the government, but also the national identity of these companies. In Malaysia, the introduction of wealth distribution from PNB, one of the Malaysian GLICs, such as Amanah Saham Nasional (ASB) then followed by Amanah Saham Bumiuptra (ASB) is helping the Bumiputra to invest their money into portfolio investment and gaining dividend every year, which was announced by PNB. Currently, PNB is the country's leading investment institution with a diversified portfolio of interests that include unit trusts, institution property trust, property management and asset management with funds under management totalling about RM150 billion. Consequently, Malaysians are expected, or anticipated, to perform better than their Singaporean counterparts do.

The testable sub-hypotheses of the study have been developed as follows:

H_03_a : Malaysian GLCs exhibit no difference in Tobin's Q compared to Singaporean GLCs

H_03_b : Malaysian GLCs exhibit no difference in stock return compared to Singaporean GLCs

H_03_c : Malaysian GLCs exhibit no difference in return on assets (ROA) compared to Singaporean GLCs

H_03_d : GLCs Malaysian GLCs exhibit no difference in return on equity (ROE) compared to Singaporean GLCs

4.5 Chapter Summary

This chapter identifies two theories relating to company performance, which are the theory of firm and the agency theory. These two theories are important because different structures of company have different ownership control. There are two models used in corporate governance, which show the structure of ownership control in general, and in government/state or family owned companies specifically. Different sets of control can lead to conflicts between owner and manager. To explain this phenomenon, another theory is applied – the agency theory conflict.

Agency theory discusses how this conflict happens and how to manage this problem through incentive contracts and legal protection. Several agency theory proxies are identified such as non-duality role and two alternate measurements of agency costs –the expense ratio (expenses over sales) and asset utilisation (sales over total asset). With these theories, three hypotheses were identified and developed for this study.