2.0 Literature Review

2.1 The Origin of CG

The imperatives of CG flow essentially from the concept of accountability for the safety and performance of assets and resources entrusted to the operating team. In a proprietory concern or small business, employees performing tasks will thus be accountable for their actions to the proprietors or partners or other owners of the business. The rigours of accountability under such circumstances are relatively easily managed since the lines of communication and supervision usually are short and straightforward. With the growth of business in size and complexity leading to the corporate form of organisation, ownership and management of enterprises get distances and consequently accountability and governance issues assume much greater significance and magnitude. A board of Directors is juxtaposed between the shareholders or owners on the one hand and the executives, managers and other employees of the organisation on the other. In effect, therefore, CG basically, has to do with power and accountability: who exercises power, on behalf of whom, and how the exercise of power is controlled (N Balasubramaniam 1999).

2.2 Accountability to Shareholders

In its generic application, the term CG is associated with accountability to a company's equity shareholders or risk-bearing owners. Conceptually, this derives from the principles of private property and the risks and rights attached to its ownership. In essence, equity shareholders pool their monies together to run a business, not very unlike several partners getting together for the same purpose. The singular difference, however, is that because of the size and complexities involved, these shareholders, unlike the analogous partners, do not manage the business but let a group of executives operate it under the surveillance of a representative Board of Directors. The form of organisation, by itself, should not make any difference to who the real owners are (N Balasubramaniam 1999).

Easterbrook and Fischel (1991) explain the reasoning in the following terms: Shareholders are residual claimants to the firm's income. Creditors have fixed claims and employees' remunerations are generally negotiated in advance of performance. The gains or losses from abnormally good or bad performance are the lot of shareholders, who stand last in the claims queue. As residual claimants, shareholders have the appropriate incentives to make discretionary decisions and bear their consequences as well. As such, shareholders do justify their claim, legally and morally, to be the owners of the business with important control rights.

The corporate structure in most countries justifies this line of analysis. In the event of bankruptcy or winding up, a comprehensive ranking of claims determines which of those take precedence and their pecking order. Clearly, the equity shareholder is last in the line and fully qualifies as the residual claimant. It is not, therefore, unreasonable for such shareholders to expect that the overall accountability of the business managers and the Board of Directors – in fact, their Board of Directors – should be to them as a class. This argument is further strengthened by the fact that the claims of at least some of the stakeholders may not be mutually congruent and often may be in conflict. A clear line of accountability to the shareholders, to the exclusion of any other stakeholders arguably with such conflicting demands is therefore, in full accord with canons of natural justice (N Balasubramaniam 1999).

2.3 Accountability to Stakeholders

While this appears to be commonly accepted position, at least in most of the Anglo-Saxon countries and others under their current or former political influence, there are several countries, which do not wholly subscribe to accountability to shareholders view. To cite one example, Germany's concept of CG covers the entire gamut of relationships between all the institutions and individual directly or indirectly involved in decision-making in an enterprise, including owners/shareholders, managers, employees, lenders, suppliers and customers. Several management thinkers have also questioned the restricted view of CG as accountability limited to shareholders and argued that such accountability be extended to other stakeholders as well (N Balasubramaniam 1999).

The rationale behind this line of argument is succinctly outlined by Margaret Blair (1995). The residual claimant theory is valid in cases where the shareholders are the only residual claimants but such corporations are the exception rather than the rule. In practice, there are numerous others besides shareholders who make investments specific to a given corporation. Employees with specialised knowledge or skills are an obvious example, as in the case of a software company or a teaching institution. Whenever investments in such specialised inputs create value, it is advantageous for the participants in the enterprise to nurture long term relationships with each other so as to extract the full value from the investments each has made. Under such circumstances, can the shareholders alone be called the residual claimants entitled to the benefits of corporate governance norms?

The debate is on. The validity of stakeholders interest in corporations, besides of course the shareholders would, in all cases, be influenced to a great degree by the firm-specific investments made by them. For example, as part of an outsourcing programme, a vendor may put up a sizable facility, wholly or even substantially, for the captive use of the outsourcing organisation. As a key stakeholder, such a vendor could well expect to benefit from the norms of accountability and governance at the outsourcing outfit.

2.4 Definition of CG

CG looks at issues pertaining to transparency, integrity, effectiveness and accountability in the management of the affairs, business conduct and all other activities of an organisation. The concern is for welfare, good performance, corporate ethics and morality and social and public responsibility for the dignity and good corporate citizenship expected of an entity.

The Cadbury Committee (1992) defines CG in the UK as the system by which companies are directed and controlled, thus placing the Board of Directors of a company in the centre of the governance system.

Josef Eby Ruin (2001) defines CG as a group of people getting together as one united body with the task and responsibility to direct, control and rule with authority. On a collective effort this body is empowered to regulate, determine, restrain, curb and exercise the authority given it.

The official definition of CG in Malaysia as adopted by the Finance Committee (1999) on CG is: **"CG 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 into account the interest of other stakeholders."**

As such, CG is the process by which companies are directed and controlled, with the Board of Directors holding ultimate responsibility for the governance of their companies. The concept of CG should not be confused with that of management. Management's role is to ensure that the company is run efficiently and effectively in all aspects, which the company is involved in, using the best managerial practises of planning and control.

The role of CG is to oversee the management that runs the business. It is a system that ensures the directors are fulfilling their functions competently, that the directors comply with all regulatory requirements beyond the corporate boundaries, and that the executive functions are appropriately controlled and accountable.

Good CG is attained through the synergistic relationship between the Board of Directors, management and the shareholders. Directors are accountable to the shareholders as they are appointed by them to advance the company's interest. Shareholders who are dissatisfied with the corporate accountability of the Directors may, amongst others, seek to remove them from office or pose relevant questions at the Annual General Meeting.

For the Boards to effectively discharge their responsibilities, the Boards need a certain level of assurance that basically, "things are running as planned". This assurance is derived from a "combined assurance" provided by the management, external audit and internal audit function.

2.5 Development of CG in Malaysia

This section traces the development of CG in Malaysia. Given the perceived need for some measure of societal expectations, several countries, particularly with developed capital markets, have documented minimum requirements appropriate to their needs and possibly also limited by the compliance capabilities of the subject companies. All these requirements reflect the needs and the moods of their respective countries around the time the committees were appointed and the reports were published. Often, they are in the nature of reactive responses to some staggering and extraordinary events or discoveries that shook up that particular society. They are also vary country-and-culture specific documents and it is neither possible not desirable to wholly adopt another country's norms without suitable adaptation to local circumstances and needs.

Nevertheless, with the long association that Malaysia has had and continues to have with the UK, and also given that the country's corporate laws and practices have been, in good measure, adapted or evolved from those in the UK.

In early 1980's, audit committees were first made mandatory for the banking sector under the auspices of Bank Negara Malaysia. This is resulting from the huge losses incurred by Bank Bumiputera Finance (BMF). The establishment of audit committees in the banking sector was meant to improve the monitoring of management activities.

In 1993, the Malaysian Government stipulated that all companies seeking listing on the KLSE must have an audit committee. This ruling of having an audit committee was subsequently made mandatory for all listing companies with effect from 1 August 1994.

The Code of ethics for Company Secretary and Code of Ethics for Company Directors were launched respectively on 4 July and 8 August 1996. With the good intent of ensuring that the top-level corporate management discharges its functions and roles honourably and responsibility the corporate world of Malaysia has witnessed two introductions of guidelines for company secretaries and directors. The ethical guidelines for these two important functional positions should augur well in the exhibition of superior corporate governance.

The Malaysian Institute of Corporate Governance ("MICG") was established in 10 March 1998 to ensure that there is a body to regulate more credible CG in corporations.

On 24 March 1998, the Malaysian government announced the establishment of a High Level Finance Committee, comprising government and industry representatives, to formulate a framework on corporate governance and setting-up of 'best practices' for the industry.

Subsequently, on 24 March 1999, the Malaysian Securities Commission ("SC") officially launched the Report of the High Level Finance Committee on CG. The Report covers three broad areas:

- Development of a Code. The proposed Code sets out a set of principles and best practices for good governance. The recommendations in the Code are directed principally at boards of listed companies. They are aimed at increasing the efficiency and accountability of boards to ensure that their decision-making processes are not only independent but are seen as independent.
- Reform of laws, regulations and rules – the recommendations for reform seek to strengthen the overall regulatory framework for public-listed

companies. They embrace key aspects of corporate regulation which include:

- Clarifying the responsibilities of key corporate participants;
- Enhancing obligations of key corporate participants, especially in related party transaction;
- Improving the accuracy and timeliness of disclosures;
- Enhancing the value of general meetings;
- Enhancing the efficiency of shareholder redress for grievances; and
- Enhancing enforcement of good corporate conduct.

➢ Training and education – A significant challenge for the corporate sector arising from implementation of the recommendations above is to expand the pool of qualified persons, namely directors to undertake the responsibilities expected of them. The recommendations, among other things, identify training and education programmes, target participants for these programmes as well the agencies to conduct these programmes (Finance Committee 1999).

Against this background, MCCG was released in its final form in March 2000. In January 2001, KLSE published its RLR, which made it mandatory for PLC to adopt numerous CG initiatives and disclosures. The RLR is also the medium by which the Code is given its practical efficacy.

2.6 Survey Findings: Pricewaterhouse Coopers

A CG survey on institutional groups in Malaysia was carried out in 1998 by Pricewaterhouse Coopers (N Balasubramaniam 1999). The findings generally suggest that Malaysia needs to uplift its standard of corporate governance so as to render a favourable climate for a systematic development of the capital market. The institutional groups perceived Malaysia's CG regime as being a little better than that of China, India, Indonesia, Philippines and Thailand and below that of Australia, Hong Kong Japan and Singapore. Key features of the survey findings are:

- Seventy-one percent of the institutions indicated that considerable improvements need to be made to the corporate governance regime in Malaysia. In this regard, more than half of the respondents indicated that if further improvements were made to the prevailing corporate governance regime, they would be encouraged to invest in Malaysia.
- A third of the respondents indicated that they would not invest in Malaysia if they found the qualification and experience of executive directors to be lacking.
- About half of the respondents felt that if the level and extent of disclosure in the accounts of a company had been unsatisfactory, they would not invest in Malaysia.
- Most (90 percent) respondents expected the SC to oversee improvements in the standard of corporate governance in Malaysia.
- One-tenth of the institutional respondents indicated that a new government department should be established to oversee further improvements in the standard of corporate governance.