CHAPTER 3

CORPORATE GOVERNANCE: A REVIEW AND SYNTHESIS OF LITERATURE

3.1. INTRODUCTION

Corporate Governance has become a major concern especially since the advent of Enron debacle. In Asia specifically, the issue of corporate governance took off seriously after the Asian Financial Crisis in 1997. The major lapses in corporate governance practices together with the 1997 financial crisis have provided the impetus for rigorous efforts for corporate governance reforms, by both government and industry, to identify and deal with weaknesses highlighted by the crisis to regain investors' confidence in the Malaysian capital market.

Prior studies in corporate governance have predominantly focused on US companies and those related to Asian countries are limited (Kiel & Nicholson, 2003). As Malaysian companies do not have similar corporate governance structures as US or other developed economies, it is not clear whether the empirical findings on US companies are applicable specifically to Malaysia with its unique institutional environment. The Malaysian institutional environment has been elaborated in Chapter 2. The purpose of this chapter is to synthesise the current literature on corporate governance and identify significant CG issues from the Malaysian perspective. This is necessary due to Malaysia’s unique institutional features i.e political economy, ownership structure, ownership concentration and legal system as discussed in Section 2.6 in Chapter 2.

This chapter is structured as follow: Section 3.2 provides an overview of corporate governance in general followed by Section 3.3 discusses the developments in the Malaysian Corporate Governance landscape. Section 3.4 discusses empirical evidence from corporate governance research in the Asian Markets. Specifically, it focuses on the CG research evidencing the institutional features, such as the political economy, ownership structure and concentration, board composition, legal systems and shareholder protection. Section 3.5 concludes the chapter.

3.2. OVERVIEW OF CORPORATE GOVERNANCE

The Cadbury Report (1992, p. 15) Section 2.5 defines corporate governance (CG) as "the system by which companies are directed and controlled". Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations and the shareholders in general meeting'".

Further, the Cadbury Report emphasises the important role of boards of directors as an agent to direct and control the firms and to communicate the true underlying financial information to the shareholders. The board of directors is presumed to perform the monitoring role on behalf of the shareholders (John & Senbet, 1998) and has the main duty of leading and directing the firm to achieve corporate goals by closely monitoring management activity so that the interest of the shareholders is well protected (Abdullah,

2004). Zubaidah *et al.* (2009) report on the outcome of the study that emphasis on the importance of outside directors on the board by the Malaysian Code of Corporate Governance and by the requirements of Bursa Malaysia is deemed pertinent to the long term corporate performance.

In the post-Asian financial crisis, corporate governance reforms have become the most important agenda issue globally. Many countries have issued Codes of Best Practices in Corporate Governance that address the basic governance issues of board effectiveness and accountability to bring greater power balance within the firm. Ng (1998) stressed that the main focus was to enhance the effectiveness of the board of directors so that shareholders' interests can be better protected by focusing on the role of board independence, effective system of controls and transparency, which are generally seen as crucial for effective governance mechanisms.

Besides the role of internal governance mechanisms, Cohen *et al.* (2004) suggest that other actors external to the corporations such as regulators, legislators, financial analysts, stock exchanges, courts and legal systems as well as stockholders also influence the interactions among the actors who are directly involved in the governance of corporations. La Porta *et al.* (1997; 1998; 2000) posit that the legal regime is the one that will precisely protect the minority interest of the shareholders.

The Organisation for Economic Co-operation and ' Development (OECD), Principles of Corporate Governance 2004 states that an appropriate and effective legal, regulatory and institutional foundation is necessary to ensure an effective corporate governance framework in any one country. To support effective corporate governance, laws and regulations, which are both enforceable and are backed by effective

government agencies, minority shareholders protection are needed to avoid abuses of minority shareholders (OECD), 2004.

Based on different institutional foundations, there are two well-known corporate governance models - the Anglo-American (one-tier system) and the Franco-German (two-tier) model. A one-tier or unitary system places the board of directors as the highest governing body in the company. In the Anglo-American system (that applies to the United Kingdom and the United States), more generally referred to as the 'market model" or 'shareholder model', the companies rely heavily on the private shareholders of the capital. Li (1994) argue that the ownership structure in Anglo-American countries is more dispersed among a large number of unrelated individual and institutional investors.

However, the two-tier system exists to serve the interests of a wide range of stakeholders and is commonly practiced in Germany and Japan. In contrast to the Anglo-American countries, the major source of capital in Franco-German countries comes from the banks. Li (1994) posit that the ownership structure in each individual firm in the two-tier system is often concentrated within a small number of directly related firms, banks and families that results in cross-shareholding between firms. All public listed companies in a two-tier system have dual boards - the supervisory board and the managerial board. The supervisory board is responsible for strategic decision-making while the managerial board is responsible for the execution of the day-to-day strategies.

McKnight *et al.* (2009) noted that, the increasing adoption of recommended governance structures provide shareholders with potentially greater information asymmetry issues.

This is evidenced from the increasing compliance that appears to be consistent with good governance but widespread adoption makes it more difficult to ascertain the impact of governance on agency costs. This could be attributed to the 'tick box' approach to governance knowing that compliance will send a message to shareholders that accountability and transparency are being taken seriously. Generally, on the corporate governance codes developed worldwide, based on the comparative analysis of the scope, coverage and strictness of recommendations of codes and classified according to the country's legal system (common or civil law), the results suggest that the issuance of codes in civil law countries be prompted more by legitimating reasons rather than by the determination to improve the governance practices of national companies (Zattoni & Cuomo, 2008).

Whilst CG reforms intensified world-wide, Malaysia introduced a fair amount of reforms since the early 1990s. In the next section, a brief discussion of the key institutions and initiatives undertaken to monitor and implement good CG practices in Malaysia are discussed.

3.3. CORPORATE GOVERNANCE DEVELOPMENT AND FRAMEWORK IN MALAYSIA

In Malaysia, efforts to improve corporate governance practices of public listed companies started as early as 1993 when the KLSE listing requirements made audit committees mandatory (Haniffa, 1999). Good corporate governance practices was further emphasised by Malaysian Securities Commission (SC) following the move from a merit-based to a disclosure-based regulatory regime in 1995 (Haniffa, 1999). However, due to the financial crisis in 1997/1998, the government was forced to intervene through rescue packages and this prompted the government to establish a

high level 'Finance Committee on Corporate Governance' (FCCG) in March 1998. The committee comprising of senior representatives of the government, regulatory bodies, industry bodies and professional associations was set to the task of reviewing corporate governance practices and recommending legal reforms to strengthen their effectiveness. Notable in these CG reforms efforts are the initiatives by the Securities Commission, the Companies Commission of Malaysia, the Malaysian Accounting Standards Board, the High Level Finance Committee on Corporate Governance, the Malaysian Institute of Corporate Governance, Bursa Malaysia, the Malaysian Institute of Accountants, and the Minority Shareholders Watchdog Group.

3.3.1. Securities Commission (SC)

According to Wan Hussin & Ibrahim (2003), the initiative to strengthen the regulatory framework of the corporate sector commenced long before the Asian financial crisis. The establishment of the Securities Commission (SC) in March 1993 was set up as a watchdog to improve the legal and regulatory framework governing the capital market. The Securities Industries Act (SIA) 1983 and Securities Commission Act (SCA) 1993, under the authority of the Ministry of Finance, represent the legislative and regulatory framework of Malaysia's capital market.

With the establishment of the SIA, the Companies Commission of Malaysia (CCM) (formerly known as the Registrar of Companies-ROC) was established to introduce the Code of Ethics for Directors in 1996 as an initiative to create effective boards. In fact, according to Liew (2007) a survey by the Asian Development Bank in 2000 found that Malaysia had the highest level of effective boards of directors as a supervision body compared to other East Asian countries - Korea, Indonesia, Philippines and Thailand.

3.3.1.1. The Malaysian capital market master plan (CMP)

An important initiative of the Securities Commission was the Malaysian Capital Market Master Plan (CMP). The CMP was launched in February 2001 and it reflected the government's proactive response to ensure the recommendations contained in the Report on Corporate Governance will be affected in a timely and comprehensive manner. In the CMP, 10 out of 152 recommendations deal with the development of the institutional and regulatory framework for the capital market from 2001 to 2010. These focus specifically on the corporate governance issues.

Further, the establishment of the Corporate Law Reform Committee, in August 2003, is to spearhead the corporate law reform programme. It is seen as another milestone for the success of corporate governance reforms in Malaysia where corporate governance issues are high on the priority of the committee.

3.3.1.2. Companies Commission of Malaysia and the Corporate Law Reform Committee (CLRC)

A parallel effort for developing an effective and sound corporate governance framework within the corporate law reform programme, is the establishment of the CLRC. This initiative was undertaken by the Companies Commission of Malaysia (CCM)[1]. The committee was formed to revise, introduce, amend or abolish a good deal of corporate law in an effort to facilitate the development of a business environment which is conducive for Malaysia. This is because, in the past, the amendment to the Companies Act i.e, the SIA and other corporate law legislation was done on a piecemeal basis.

In a nutshell, the CLRC is to do with modernising Malaysian company law to be in tandem with the development of company law of other leading common law jurisdictions such as the UK, Singapore and Australia. The government on its part, supports the review exercise that is being conducted by the CLRC, as it is committed towards ensuring that the corporate regulatory framework in Malaysia continues to promote enterprise and competitiveness. Further, this representation is necessary for a comprehensive, modern and balanced view of the corporate reform in Malaysia.

3.3.2. Malaysian Accounting Standard Board (MASB)

In 1997, Malaysia became the first country in Asia to set up an independent standard setting body, the Malaysian Accounting Standards Board (MASB), under the Financial Reporting Act (FRA) 1997 (Wan Hussin & Ibrahim, 2003). The MASB is an independent authority to develop and issue accounting and financial reporting standards in Malaysia, and, under the FRA, all companies listed on the KLSE are required to comply with the accounting standards approved by the MASB. MASB's mission is to develop and promote high quality accounting and reporting standards that are consistent with international best practices for the benefit of users, preparers, auditors and the public in Malaysia with direct contribution towards the international development of financial reporting.

3.3.3. The High Level Finance Committee on Corporate Governance and the Malaysian Institute of Corporate Governance (MICG)

In response to the Asian Financial Crisis, the government took proactive action to review and strengthen corporate governance in Malaysia with the establishment of the High Level Finance Committee on Corporate Governance in 1998 comprising

government and industry representatives. Its task was to identify and address weaknesses highlighted by the 1997 financial crisis and to establish a framework for corporate governance best practices. Consequently the Malaysian Institute of Corporate Governance (MICG) was established in 1999.

The inception of MICG on the other hand is to raise the awareness and good corporate governance practices by businesses and corporate development in Malaysia. The main mission is to improve and promote corporate governance best practices as well as to strengthen corporate governance principles and compliance efforts. Further, it also provides an independent platform for various stakeholders to interact and debate corporate governance issues to promote continuous improvement in corporate governance best practices.

Malaysian corporate governance's model has very much followed the Anglo-American system where the framework is driven mainly by concern for shareholders' interest (Abdullah, 2004). In the Anglo-American system or generally referred to 'market model' or 'shareholder model', the board of directors play an important role as the highest internal control system in the company to monitor the performance of management (Abdullah 2004). Ow-Yung & Guan (2000) reports, that the historical connection between Malaysia and the UK was basically modelled after the UK Combined Code on Corporate Governance.

3.3.4. The Malaysian Code of Corporate Governance (MCCG) and Bursa Malaysia

Bursa Malaysia [previously known as Kuala Lumpur Stock Exchange (KLSE)] has adopted most of the recommendations of the Malaysian Code on Corporate Governance

(MCCG) 2000 in order to enhance the transparency of public listed companies' disclosure. The Code was brought into full effect in January 2001 with the amendment to the Bursa listing requirement. All listed firms with a financial year ending after 30th June 2001 onwards were required to include in their annual report - the statement of corporate governance, a statement of internal control, composition of the board of directors, composition of audit committee, quorum of audit committee and any additional statements by the board of directors (Kuala Lumpur Stock Exchange, 2001).

The MCCG 2000 established the board of directors as the first principle and under Part 2 (AA) of MCCG 2000, the role, composition and structure of the board of directors are viewed as the most crucial elements for effective corporate governance mechanisms for Malaysian companies. The Code recommends that firms have a well balanced and effective board to take the lead role in establishing best practice in corporate governance and the code defines a well-balanced board as having a balance of executive directors and non-executive directors, including independent non-executive directors, to ensure effective decision making by the board with no domination from individual or small groups of individuals. Additionally, the Code also requires that non-executive directors have the necessary skills and experience and be persons of calibre and credibility in order to bring independent judgment to the board.

The MCCG has also strongly recommended for the separation of responsibilities between the CEO and chairman although the Bursa Malaysian Listing does not put this as a criteria. Other areas where there has been strong emphasize from the MCCG is that all board of directors should maintain a sound internal control system, to address in their annual reports the Principle and Best Practices relating to internal control i.e to

identify principal risks and ensuring the implementation of appropriate measures to address business risks.

MCCG 2000 was revised on 2007 and the revised code mainly strived to strengthen the role of audit committee by requiring the committees to comprise fully of non-executive directors. In addition, all its members should be able to read, analyse and interpret financial statements so that they will be able to effectively discharge their functions. The key amendments to the code is aimed at strengthening the Board of directors (BOD) and audit committees and ensuring that BOD and audit committees discharge their roles and responsibilities effectively.

Further, the Bursa Saham Malaysia called for all directors to undergo continuous training (i.e. Mandatory Accreditation Programme and Continuing Education Programme) to enhance their capabilities in performing their responsibilities as directors as well as to influence corporate thinking on issues relating to corporate governance (Zulkafli *et al*.,2005). The programme aimed at enhancing the competency and professionalism of company directors and is a prerequisite to continued listing. Companies with a financial year-end of 31 December 2005 onwards were required to disclose the training attended by the directors in the annual report (Wan Hussin & Ibrahim, 2003).

3.3.5. The Malaysian Institute of Accountants

The Malaysian Institute of Accountants (MIA) is a statutory body established under the Accountants Act, 1967 to regulate and develop the accountancy profession in Malaysia. MIA's responsibilities include education and quality assurance as well as enforcement

which are carried out to ensure that the credibility of the profession is maintained and that public interest is continuously upheld (www.mia.org.my). In the international and regional arena, MIA plays a significant role in developing and advancing the global accounting profession through its involvement in organisations such as the International Federation of Accountants and the Confederation of Asian and Pacific Accountants (CAPA).

3.3.6. Minority shareholder watchdog group (MSWG)

A futher key initiative undertaken was the establishment of the Minority Shareholder Watchdog Group (MSWG) in 2001, which is to encourage independent and proactive shareholder participation in listed companies. MSWG functions as the think-tank and resource centre and as an effective check and balance mechanism on behalf of the minority shareholders to deter abuse from the majority shareholders. The MSWG is a non-profit organisation representing the five largest institutional funds in Malaysia, namely. the Employee Provident Fund (EPF), Lembaga Tabung Angkatan Tentera (LTAT), Lembaga Tabung Haji (LTH), Social Security Organization (SOCSO) and Permodalan Nasional Berhad (PNB) (Abdul Wahab *et al,* 2007).

3.3.7. Malaysian Corporate Governance Reforms: A Summary

In summary, the efforts by Malaysia in reforming its CG landscape yielded visible results. Cornelius (2005) documented that based on the Global Competitiveness Report, Malaysia has performed well across the different governance dimensions and that the average quality of governance practices is actually higher compared to some more advanced OECD markets. Indeed, the ten year period after the financial crisis witnessed

a tremendous change in the Malaysian regulatory framework to strengthen the financial and capital market in the country.

Clearly, at the policy level the MCCG provided the mechanisms and recommendations to restore investor's confidence and trust in management, and that the recommended governance structures in enhancing corporate performance and transparency sets a stage for a continuous process to good corporate governance. However, since 2001 when these initiatives were adopted, the evidence of the implementation effectiveness and the resultant impact has been mixed.

Malaysia has seen several subsequent high-profile cases of corporate misconduct, such as, Transmile and Meagan Media, just to name a few. Furthermore, the KPMG (2005) Fraud survey report revealed that corporate fraud in Malaysia is on the rise and the statistics show that about 62 percent of the respondents found that fraud is a major problem in Malaysia and 83 percent of the respondents acknowledge experiencing fraud in their organisations. Whilst the capital market is an increasingly vital source of financing for Malaysia, growing by a five year compounded annual growth rate of 9.2 percent from RM 27.4 billion in 1999 to RM42.7 billion in 2004 (James, 2005), the economy grew at a slower pace of 0.1 % in the fourth quarter year, compared with 7.1 % in the first half of 2008 due to a drop in investors' confidence in the market.

The importance of good governance practices to strengthen the Malaysian financial and capital market has been recognised (Abdul Rahman, 2006). However, according to Liew (2007) p.729, it was obvious that the efforts and initiatives by the government, prior to the crisis, clearly did not prevent the 1997/1998 crisis from adversely affecting the Malaysian capital market. The possible reasons for the dismal results can be

attributed to i) the initiatives merely rhetorical, superficial reforms; or ii) the implementations was implemented too late to prevent runs on the nation's currency or major capital outflows (Liew, 2007).

The next section discusses the empirical evidence from CG research in Malaysia and the Asian markets.

3.4. CORPORATE GOVERNANCE ISSUES IN THE ASIAN MARKETS

As discussed in Chapter 2, Section 2.6, Malaysia exhibits some unique institutional features that are somewhat also evident in the Asian emerging markets. In this section, the CG research evidencing the specific institutional features, such as the political economy, ownership structure and concentration, board composition, legal systems and shareholder protection, are discussed.

3.4.1. Corporate governance and company performance

Poor corporate governance has been cited as the major cause of the downfall of several East Asian economics during the 1997-1998 financial crises. In fact it was due to the solid macroeconomic fundamentals like low budget deficits, low inflation and high growth domestic product (GDP), growths during the preceding years preceding the crisis obscured the weaknesses on the overall corporate governance system and structures inappropriate to open economics (Sawicki, 2009). This crisis led to intense liquidity problems in Asian markets due to a significant withdrawal of investment from foreign investors as a result of the loss of confidence in the Asian capital market.

Pomerleano (1998), examine the corporate performance of seven East Asian economies and indicate that corporations in East Asian economies suffered significant damage as a result of high debt equity ratios and that a large number of Asian corporations became insolvent and had to recapitalise during the Asian financial crisis. The crisis, however, shed light on the fundamental issues that encompass good governance practices in East Asian emerging markets. Cheung & Chan (2004) reiterated that the promotion of good corporate governance practices is seen as a necessary step to promote the development of local equity markets as well as to provide a higher level of foreign investor confidence in the Asian capital market. Ng (1998) document about the current state of corporate governance in East Asia where it clearly lags behind that practised in developed Western economies. Further, Yoshikawa & McGuire (2008) document that as the evolution of corporate governance practices is a very complex process that involves the interaction between internal and external players, the forces for both change and continuity in corporate governance varies within countries and needs to be examined in an institutional context and through organisational choices to understand the specific institutional arrangement.

Tam & Tan (2007) evidence significant differences in corporate governance practices by different type of owners in Malaysia. Concentration of shareholding is prevalent with different types of owners exhibiting distinct traits of behaviour and preferences for corporate governance practices that aim to enhance the interest of the majority shareholders. The results suggest that the protection of shareholders rights, particularly those of the minority shareholders remains a key issue in Malaysia, as large shareholders exert great influence via ownership concentration or board control.

3.4.2. CG and Asian institutional features

3.4.2.1. Political economy

A pertinent issue relating to Asian economies is the impact of political influence on financial reporting practice (Ball *et al.,* 2003; Gul, 2006). Government intervention in the financial reporting process varies across Asian economies with the Hong Kong government adopting a lazier-faire approach, the Malaysian and Singaporean governments taking a more interventionist approach and a more direct approach from the Thai government in standard setting and financial reporting practices (Ball *et al.,* 2003). In business, there exists a close connection between governments and large corporations in Asia, often termed as 'crony capitalism' (Ball *et al.,* 2003). These crony companies' ties with government-linked companies have often been cited for poor stock performance (Chu & Cheah, 2006).

Francis *et al.* (2009) evidenced that the Chinese firms with political connections reap significant preferential benefits in the process of going public. In fact, irrespective of their ownership status, with greater political connections, Chinese firms have relatively higher offering price, lower under pricing and lower fixed costs during the going public process. In contrast, in the Malaysian perspective (as discussed in Chapter 2), an important factor that has shaped Malaysia's capital market is the close identification between racial and economic functions. Ethnicity has shaped how the country and businesses are run externally, through political means (Mohammad *et al.,* 2006). Further, Gul (2006) found that there is a greater increase in audit fees for firms with political connections than for non-political connected firms as a result of the Asian

financial crisis; however, there is a decline in audit fees for politically connected firms after the capital controls has been implemented.

3.4.2.2. Ownership structure

Approximately 58 percent of all Asian companies can be classified as being family owned (based on 20 percent cut-off point) where Hong Kong (66.7 percent) and Malaysia (67.2 percent) show the highest degree of family ownership of total market capitalisation controlled by family groups (Cheung & Chan, 2004).

Family control in Japan is insignificant i.e the ten largest families own only 2.4% of the market capitalisation (Claessens *et al.,* 2000). On the state of group ownership of corporations in East Asian economies, Cheung & Chan (2004) report that Singapore has the highest level of state-controlled listed companies compared with other East Asian countries with a market value of 23.5 percent, followed by Malaysia with 13.4 percent of value under state control. Expectedly, when the family ownership and state ownership are both included, the Asian stock exchanges represent about 70 percent of market capitalisation, which suggests a domination of family-controlled firms and state-controlled firms in East Asian markets.

What is the current position? In Malaysia, the 'primary founder as the prime shareholder still dominates the business practice (Miles, 2009). Ming & Gee (2008) found that Malaysian institutional shareholders have failed in their monitoring role and principle agent problem will not be solved merely by increasing the director's shareholding. This result was found to be consistent despite segmenting the company according to market capitalisation.

More recently, Zubaidah & Fauzias (2010), highlight the importance of moderating role played by board governance variables with types of ownership structure to influence firm value. However, the benefits of better corporate governance through enhanced board governance are not the same across all firms as they vary with respect to dividend and different types of ownership structure mechanism.

Another issue of concern relating to Asian corporate governance is the significant concentration of control rights with Thai and Indonesian companies having the concentration of 35.25% and 33.68% respectively followed by Malaysian and Hong Kong companies at 28.32% and 28.08% respectively The least concentration of control rights is documented in Japan, Korea and Taiwan.

3.4.2.3. Concentration of ownership

On the separation of ownership and control in state controlled firms, Malaysia seem to have a measurable wedge between ownership and control in firms controlled by widely held corporations and the largest separation is held in small firms at approximately 78.9 percent. Whilst, the Japan-Keiretsu and Korea-Chaebol evidence that cross-business shareholdings exacerbate tunnelling or managerial opportunism by controlling shareholders through discretionary accruals that cause the market to discount the discretionary accruals of firms with high cross-business shareholdings, evidence is limited from the Malaysian context.

In Malaysia and Singapore the cross ownership is at 14.9% and 15.7% respectively. Further, Chen *et al.* (2005) found positive relationship between family ownership and

return on assets, return on equity or the market to book assets. On the separation of ownership and control in state controlled firms, Malaysia is the only country with a measurable wedge between ownership and control in firms controlled by widely held corporations and the largest separation is held in small firms at approximately 78.9 percent. Further, Ang & Ding (2006) posit that Singaporean GLCs have higher valuations and better performance than a control group of non-GLCs. The results are also consistent when there is control for firm specific characteristics such as profitability, leverage, firm size and foreign ownership. In the context of ownership concentration, Nowland (2008) found that companies from Hong Kong, Indonesia, Malaysia, Singapore, South Korea and Thailand are more likely to improve their board governance. In fact the study also found that splitting the position of the Chairman and CEO, creation of audit committee and nomination committees has been followed by a year of increase in value.

3.4.2.4. Board composition

Cheung & Chan (2004) examine the issue of board composition (such as a number of independent non-executive directors) when inside directors dominate the board. As the directors are elected by the controlling owners, it raises doubts as to whether the independent directors are truly independent and provide an adequate degree of monitoring of the majority shareholders. Given that the supply of qualified independent directors is limited in many Asian countries, the issue of board independence is critical and the requirements for a majority of independent directors who are truly independent, seems unattainable in substance for Asian corporations (Barton *et al.,* 2004).

However, Sing & Ling (2008) document the important role played by the board in governance and influencing strategic decision makings, given that both insiders and block holders seek to dominate membership. The competing interest can be seen as both parties trying to outweigh each other. Hence, independent directors in Malaysian firms generally play a passive role as their appointment is merely to fulfil listing requirement rather than as a measure at improving corporate governance or to bolster the capability of the firm.

In contrast, Zubaidah *et al.* (2009) found and support the requests for a minimum number (one third of the board) of independent non-executive directors on the board by the Bursa Malaysia Listing Requirements and the MCCG as very relevant and significant. The reason being, independent directors possess a diverse background, attributes, characteristics and expertise which may improve board processes, decision making, contribute towards intellectual resources of the firm and consequently firm performance.

3.4.2.5. Legal system

As discussed in Chapter 2, the legal system is another key institutional feature which isis an important consideration in setting an effective corporate governance framework, as two companies in two different countries may experience different legal, regulatory and market standards (Cornelius, 2005). The legal systems might also present barriers for enforcing corporate governance principles in Asian countries as the legal systems and enforcement are still developing institutions and laws (Cheung & Chan, 2004). DeMiguel *et al.* (2005) show that the main institutional factors (i.e. investor protection, development of capital markets, activity of the market for corporate control and

effectiveness of boards) embodied in a corporate governance system affects the relationship between ownership structure and performance.

Further, the existence of non-linear relation between insider relationship and dividend payout is clearly depicted between the two legal and institutional environments (civil law or common law) within which the firms operate. Malaysia comes under the common law system, and hence under the common law system, the role of the dividend policy has been established as a disciplining mechanism in countries with different legal systems and distinct agency problems (Farinha & Lopez-de-Foronda, 2009).

3.4.2.6. Shareholder protection

In countries with poor shareholder protection, the controlling owners, either state or families, have control over firms in excess of their cash flow rights and have the power to expropriate the minority shareholders. Consequently improving the legal environment is difficult, which raises the question of minority shareholders protection (La Porta *et al.* 1999). Mitton (2002) found that firm-level differences in variables, related to corporate governance of five Asian countries, i.e. Indonesia, Korea, Malaysia the Philippines and Thailand, have a strong impact on firm performance during the 1997/1998 financial crisis.

Further, Sawicki (2009) posit that there is a clear distinction between the three common law countries (Singapore, Hong Kong and Malaysia) on the basis of ownership concentration, legal and corruption indices. A strong positive relationship between governance and dividend emerges from post crisis, consistent with substantial improvements in governance empowering shareholders. Hence, the relationship is

incremental to the effect of the legal regime, confirming that shareholder protection at the firm level is important to forcing firms to disgorge cash in an outcome model of dividends.

3.4.2.7. Minority Shareholder protection

Further, Sawicki (2009) posit that dividend payout is a clear effective mechanism, especially useful to firms lacking other sources of reputation. Governance scores improved substantially for Malaysia, after the onset of the crisis and after reforms was instituted, higher dividends was paid by better governed firms, indicating that the influence of governance in protecting minority interest rights was by forcing more cash to be returned to investors. The findings also indicate that dividends are an outcome of both legal and internal mechanism protecting minority shareholders interest and hence confirming that both the firm and country level governance are important in shaping the nature of investor protection.

3.4.3. A Summary

In summary, Corporate Governance (CG), both as a practice and as a public corporate philosophy, represents good business practices from a financial perspective (Miles, 2009). In ten of the 11 Asian markets, including both Hong Kong and Malaysia but excluding Korea, companies in the top quartile for CG average 10 percentage points above their respective country averages in higher return on equity (ROE), return on capital employed (ROCE) and CG performance. However, one of the key reasons for underperformance for companies lacking good CG is that investors, particularly institutional investors are now wary of stocks of companies having perceived low CG.

In fact, erosion of investor confidence is self-fulfilling, causing reduced stock valuation and a negative spiral of firms' financial performance (Miles, 2009). The discussion of the institutional features and CG nexus indicates the importance of considering the institutional context in examining CG - dividend payout relationship.

3.5. CONCLUSION

This chapter discusses corporate governance practices and its development worldwide, in the Asian region as well as in Malaysia. There are sufficient evidence to show that in many aspects the internal and external corporate governance practices differs between East Asian corporations and developed markets. In the next Chapter, the dividend puzzle and the dividend payout and governance literature is deliberated.