

5. CORPORATE GOVERNANCE IN POLITICALLY CONTROLLED FIRMS

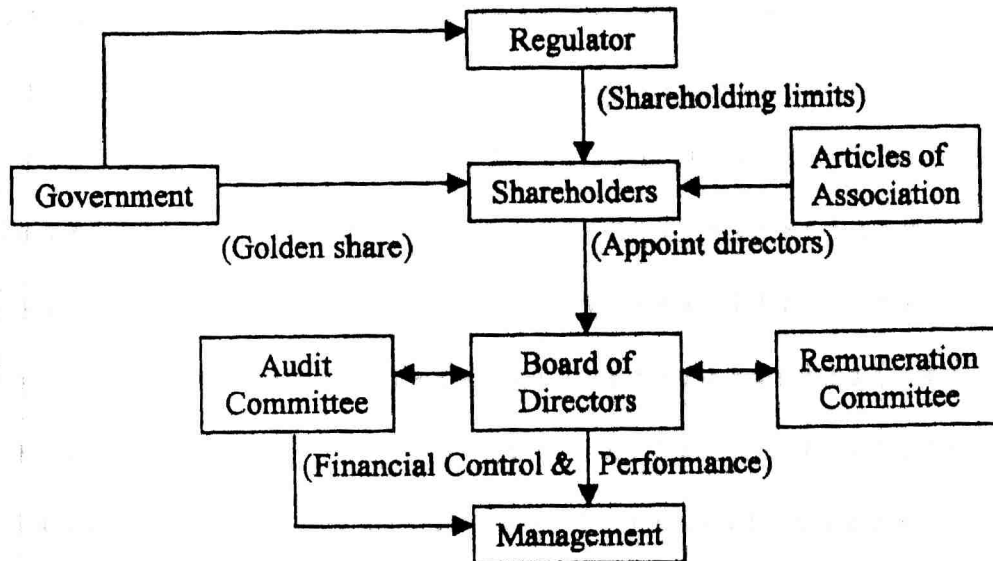
Politicians are motivated by their own self-interest just like everybody else. Since politicians' main objective is to gain votes for the next election as well as to get as much rents as possible from their position, the monitoring of these firms will be affected. This chapter will try to find out what are the factors that would be against the corporate governance objectives and whether the arguments that political ownership is bad for governance can be supported.

Boardman and Vining (1989) found that state owned enterprises and mixed enterprises perform equally poorly as compared to private enterprises. Their results suggests that partial privatisation where the state retains control of the firm may not be enough for the firm to operate efficiently.

Five privatised companies are selected to evaluate its performance and to examine whether political ownership had any effects on corporate governance. The companies are Malaysian Airline System Bhd (MAS), Malaysia International Shipping Corporation Bhd (MISC), Telekom Malaysia Bhd (TELEKOM), Tenaga Nasional Bhd (TNB) and Petronas Gas Bhd (PGAS). The companies are selected based on their size and influence on the economy as measured by their market capital and total turnover. Some of these companies also have some form of monopoly power. These privatisation share offerings are also some of the largest equity offerings ever made in the country. All these companies are still fully controlled by the government as it maintains a majority shareholding.

The selected companies will be evaluated based on the following criteria: the composition of the boards, audit and remuneration committees, special rights preference share, shareholding limits and financial control and performance. These informations are taken from the respective annual reports and prospectuses. Comparison will be made on companies before and after privatisation whenever data is available. Figure 3. briefly shows the framework of a politically controlled company.

Figure 3. A framework of a politically controlled company



The review suggests that political control is very strong so much so that the directors are protected by the legal system. This means that if there is bad management it could be tolerated. The only entity that is legally entitled to monitor this kind of firms is the government and politicians themselves. This arrangement will not be transparent and is open to abuse. The review also shows that it is still a long way before these firms can achieve an acceptable standard of corporate governance.

5.1 The Board

For these government controlled firms, after capital is raised through a public equity offering, there should not be any major changes in the structure of the board or its members as the government remains as the largest shareholder. As expected, there are not many changes in the number of directors on the board. All the companies retain virtually the same members of the board immediately after divestment. After at least five years of divestment, out of the five companies, three increased the number of directors on the board, one reduced the number of directors and one made no changes. Of the three that increased their number of directors, two of them increased the number of non-executive directors. The one that reduced its number of directors also increased its number of executive directors. The average size of the board is 10.4 members compared to 9.8 before divestment. Non-executive directors dominate the boards making up an average of 88.4% of the boards. Before divestment, the average was 89.2%. Non-executive directors consist of those representing the state as well as those appointed to represent other shareholders. Table 11. shows the composition of the boards of the five-privatised companies before and after divestment.

Table 11. Composition of the boards of privatised firms

Company	Date listed	Board composition before privatisation			Board composition after privatisation		
		Year used	Executive directors	Non-executive directors	Year used	Executive directors	Non-executive directors
MAS	Dec 1985	Mar 1985	1	10	Mar 1995	1	10
MISC	Feb 1987	Dec 1986	1	11	Dec 1995	2	9
TELEKOM	Nov 1990	Sep 1990	2	7	Dec 1995	1	10
TNB	May 1992	Feb 1992	0	10	Aug 2000	1	10
PGAS	Sep 1995	Jul 1995	1	6	Mar 2000	1	7

Source: Prospectus and Annual Reports.

A review of the boards shows that directors are from diverse backgrounds representing the respective shareholders. All the current directors do not have any major direct interest in the companies. The shares held by them are token shares, allocated to some of them by virtue of their position as directors. Until and unless the directors invest in the firm with their own money, there will be no real interest for the directors to maximise their effort on the firm. One exception is MAS, which until end 2000 has a major shareholder, Tan Sri Dato Tajudin Ramli who had interests in the company through Naluri Bhd. He was the Chairman of MAS until the company was taken over by the government. The MAS board also had another director representing a major shareholder other than the government. The director represented the Brunei Investment Agency, which held a major stake at that time as well. Ironically even though the director of this board, which had cashflow rights as well as control, rights, the firm still could not perform up to expectation. There are nine members and no executive directors on the board as at 31/3/2000. However the backgrounds and independence of the directors are unknown, as it is not disclosed in their annual reports.

There is a slight similarity in the current boards of MISC and PGAS. They share the same chairman, Tan Sri Dato Mohd Hassan b. Marican. They also share the same holding company, Petroliam Nasional Bhd (PETRONAS). On 31/3/2000 the board of MISC had six members with one executive director while PGAS had eight members with one executive director. The small number of directors on the board reflects the full control of the board by PETRONAS. The annual reports for these two companies also did not disclose the backgrounds of their directors and which directors are independent. Since the directors of these two companies do not hold significant shares

in the companies, it can be expected that they are employed and represent the holding company PETRONAS.

On the other hand, the current boards of TNB and TELEKOM are larger than the others with most of the directors appointed by the government being the major shareholder. Their latest annual reports have the best disclosure on the boards and background of their directors of all the five companies. On 31/8/2000, the TNB board had eleven members with one executive director. Out of the eleven members, nine are independent non-executive directors. The Ministry of Finance (MOF) appoints five directors while the remaining six are elected by shareholders. This reflects the rights of the 'golden share' held by the MOF. Of the five appointed directors, one is a Deputy Secretary-General in the MOF, one is the Secretary General in the Ministry of Energy, Communications and Multimedia and one is the Director General of the Malaysian Industrial Development Authority (MIDA). The backgrounds of the other directors include three engineers, one of which is a former engineer of the National Electricity Board (NEB) and currently the CEO, two accountants, one land surveyor, and two politicians, the Member of Parliament (MP) of Rompin and the former Secretary General of Parti Gerakan Rakyat Malaysia (GERAKAN).

TELEKOM had twelve members with two executive directors on the board as at 31/12/2000. The TELEKOM board had six independent non-executive directors. The government appointed directors include a Deputy Secretary-General of the MOF and a Deputy Secretary-General of the Ministry of Energy, Communications and Multimedia. Other directors include a former Director General of Telecommunications, a former central banker who is the current CEO, a former

Executive Chairman of the Securities Commission, four engineers, three of them formerly from Jabatan Telekom Malaysia (JTM), one accountant, and two MPs. This seems to show that the boards of both TNB and TELEKOM have heavy political influences.

All the companies have complied with the Malaysian Code on Corporate Governance (MCCG) regarding independent non-executive directors. It is stated in the MCCG that independent non-executive directors should make up at least one third of the membership on the board. However PGAS did not disclose the number of independent non-executive directors in their annual report. As such it cannot be evaluated. Although the number of independent non-executive directors are more than the minimum number required, political influence in their ranks are high. This is reflected in their backgrounds. Therefore it is more likely that they represent the interests of their political masters than other shareholders. The independence of the directors is difficult to ascertain.

Except for TELEKOM the other boards do not deemed it necessary to have a corporate governance statement. It is a step forward for TELEKOM to have this statement mentioning what actions have been taken and what further actions will be considered to enhance corporate governance. As for the other companies, the lack of urgency on their part on the matter of corporate governance is greatly reflected by the quality and disclosure of their annual report. Examples include not disclosing the background or independence of the directors, no corporate governance statement and no disclosure of directors' remuneration.

Shareholder and investor communication is also important. Most of these companies communicate with shareholders and investors during the announcement of their quarterly results. Recently the internet has been used to communicate by including the relevant information on their websites. However webcasting is still not widely used. This can be an important and cost effective tool for shareholders and investors to play a more active role in the company. Further possibilities of using the internet are voting over a secured network system. If this is possible and including webcasting, shareholders need not be physically present at the annual general meeting and yet are able to exercise their rights. This will encourage more minority shareholders to vote.

5.2 Audit Committee and Remuneration committee.

There are two important sub-committees of the board, which plays important corporate governance roles. They are the Audit Committee and the Remuneration Committee. All the five companies in this study already have an audit committee for some time. Except for MAS and MISC which was privatised earlier, the other three companies established their audit committee before being listed as a result of the listing requirements of the KLSE (Rule 344A KLSE Listing Requirements). With the inclusion of the audit committee ruling as a listing requirement, all companies seeking listing in the KLSE had to comply. MAS established its audit committee in 1992, seven years after being listed while MISC six years after listing. These two companies establish their audit committees rather late in response to the KLSE rule change. Without the audit committee means that the board would not be effectively monitoring the management. There is no other proper channel for monitoring apart from through the CEO or managing director.

Table 12. shows the year that audit committees are established by the five companies studied and Table 13. shows the make up of the audit committee. All the audit committees complied with the MCCG requirement that audit committees should make up of at least three non-executive directors of which the majority is independent. The MAS audit committee is made up fully of independent non-executive directors while MISC and TNB have one executive director each. TELEKOM and PGAS have one non-executive director in their audit committee who is not independent. The quorum for the five audit committees studied is between 50% and 66%.

Table 12. Year Audit Committees was established.

Company	Date listed	Year Audit Committee was established
MAS	16-12-1985	1992
MISC	23-2-1987	1993
TELEKOM	7-11-1990	1988
TNB	28-5-1992	1990
PGAS	4-9-1995	1995

Source: Annual Reports.

Table 13. Members of the audit committee.

Company	Year End	Number of members				Total	Quorum
		Exec.	Non-exec.	Ind. Non-exec			
MAS	31-3-2000			4	4	2	
MISC	31-3-2000	1		3	4	2	
TELEKOM	31-12-2000		1	4	5	3	
TNB	31-8-2000	1		4	5	3	
PGAS	31-3-2000		1	2	3	2	

Source: Annual Reports.

However Remuneration Committees do not seem to be important to the companies studied. Except for TELEKOM, the other four companies do not have a remuneration committee at all. TELEKOM established a Board Nominating and Remuneration Committee in November 2000. It comprised of four non-executive directors of which

three is independent. Although TELEKOM have a remuneration committee, it did not disclose any details of remuneration of the directors. It seems that Malaysian directors are generally reluctant to disclose their remuneration. Datuk Megat Najmuddin Khas, president of the Malaysian Institute of Corporate Governance (MICG) was quoted as saying "...they are not used to disclosing this and the culture has been such... here this is a sensitive issue" (Investors Digest, July 2000). The MCCG has recommended that company's report should contain details of the remuneration of each director. Although the MCCG is voluntary in nature, time will tell if the relevant regulatory bodies like the KLSE will actually put this recommendation into their listing rules. However the KLSE has taken certain steps to enhance disclosure. Beginning in March 1999, all listed companies are required to disclose their financial performance quarterly.

5.3 Special Rights Preference Share

Apart from PGAS, all the other companies have a special rights preference share held by the government through the MOF. Generally the rights of this preference share include the right to appoint directors to the board and the right to veto any alteration to the Articles of Association, disposal of assets, amalgamation, merger, and take-over proposals. Under this arrangement, the provisions in the articles on the appointment of directors do not apply to the government appointed directors. This means that government appointed directors are not subject to retirement by rotation and not elected by shareholders. Since the directors are not elected by the shareholders, their accountability to the shareholders other than the government may be affected. This situation puts the responsibility on the monitoring of the directors

solely on the government because no other party has the right to remove them if they are not performing. The arrangement is not in accordance to the MCCG, which recommends that all directors should be required to submit themselves for re-election at least every three years. The exemption given to the government appointed directors means that the shareholders opportunity to review the performance of the directors is taken away. Given that the government appointed directors make up about 50% of the board the potential implication is very high.

For MAS, TNB and TELEKOM, the holder of the special rights preference share are entitled to appoint not more than six directors out of a maximum of twelve directors including the chairman and managing director (Annual report, 1985, and prospectuses dated 26/9/1990 & 29/2/1992 respectively). The rights to appoint directors for the special share in MAS was changed from six directors to not more than three directors in preparation for further divestment (Annual report, 1995). However the special share may prove a hindrance for companies which plans to expand overseas. This is because most governments do not allow companies with 'golden share' to purchase stakes in companies involved in important industries such as utilities. A company with a 'golden share' is considered a government-controlled company.

5.4 Shareholding limits

Limits on shareholding can be beneficial because it improves liquidity, diversify shareholdings and prevents any party from dominating or taking a controlling stake, which could lead, to a take-over. This move is used by many founders or family controlled companies to prevent a take-over after listing or to prevent their controlling

stake from being diluted over time. These limits are used extensively in the US because of its anti-trust concerns. However for a mature market like the US, most controlling stakes are small as compared to Asia for example. Shareholding limits have its problems as well. It prevents a take-over market from developing and at the same time protects the incumbent management. Take-over is part of a competitive market mechanism.

There are two types of limits. Limit by the company that is stated in its articles and limit by the government. Limit by the government is on foreign shareholding, which is monitored by the Foreign Investment Committee (FIC). The foreign ownership limit for MAS and MISC is 30% while the limit for TELEKOM and TNB is 25% (Respective prospectuses). Information on limits for PGAS is not available. TELEKOM and TNB also impose limits on individual shareholding. For TELEKOM, any person other than the Government of Malaysia are limited to only 5% of shareholdings while for TNB the limit is 10%. If the market mechanism does not work properly due to barriers such as these limits, then the government as the only significant shareholder will have to ensure that the directors appointed are capable of doing the job. Since there is no other possible alternative to control directors' performance, pressure will be on the government's own monitoring system to work.

Another kind of limit is the 30% limit for bumiputra shareholdings, which is set by the NEP for distributive purposes. This is clearly another barrier for market disciplinary mechanism. However the implications here is different from the two limits discussed earlier. This is a minimum limit instead of maximum limit in the others. Therefore it is no barrier if you are a bumiputra. It could make it easier for

bumiputra investors to collectively takeover a firm while at the same time make it difficult for the others to do the same.

5.5 Financial Control and Performance

Financial control figures are seldom released to investors. The only time that the directors feel the need to release their control figures such as a profit forecast is when they need to raise funds from the investors. This is evident when all five companies studied disclosed a forecast for their profit and dividend in the prospectus prior to any IPOs or rights issues but have not included any forecasts in their annual reports. The Chairman's Statement, CEO and Directors' Report in the annual reports never mention about any forecasts or expectations of the company for the future. Most reports would mention the past year performance only. The better ones would have a general growth outlook for the economy and their industry but no figures on their own expected performance. Therefore shareholders will have to depend on forecasts by analysts and this service may not be cheap or made available to all investors.

From the financial control figures made available in their prospectuses, four of the five companies studied perform better than their forecast. The only exception being MAS. However MAS figures was taken from the rights issue prospectus dated 26 June 1992 and not from the IPO prospectus as the others because its IPO prospectus is not available. It is believed that some of these forecast figures may be intentionally reduced to generate better results and attract investors as some of them are natural monopolies and the fact that the forecasts are made at a time when the economy is growing rapidly. Even though the profit and dividend forecasts is made available in

the prospectus this information is still limited because important controls like external financing limit is not disclosed. External financing limit is important because it could possibly prevent investors from investing in companies that are vulnerable to a crisis like the one in 1997. Table 14(a) and (b). shows the figures for the financial controls mentioned.

Table 14(a). Company performance and financial controls

Company	MAS*	MISC		PGAS
	Mar 1993	Dec 1986	Dec 1987	Mar 1996
Profit forecast				
Specified amount	RM372m	RM237m	RM245m	RM711.2m
Actual amount	RM158m	RM243m	RM288m	RM731.8m
Dividend forecast				
Specified amount	12.5% per share	5% per share	12% per share	6.67% per share
Actual amount	10% per share	17.5% per share	12.5% per share	15% per share

Table 14(b). Company performance and financial controls

Company	TELEKOM		TNB	
	Dec 1990	Dec 1991	Aug 1992	Aug 1993
Profit forecast				
Specified amount	RM557m	RM925m	RM1065m	RM1245m
Actual amount	RM563.7m	RM1079.6m	RM1412.3m	RM1845.9m
Dividend forecast				
Specified amount	5% per share	12.5% per share	6.66% per share	6.66% per share
Actual amount	5% per share	12.5% per share	6.66% per share	12% per share

* From rights issue prospectus dated 26/6/1992.

Source: Companies prospectus on initial public offer.

The financial performances of the companies studied have improved after privatisation. However the performance of MAS may not be as consistent as the other companies. The following is a summary of the proxies used: -

Return on Assets (ROA) = Net Income / Total Assets

Return on Equity (ROE) = Net Income / Equity

Net Income Efficiency (NIEFF) = Net Income / Number of Employees

Sales Efficiency (SALEFF) = Sales / Number of Employees

Capital Expenditure to Sales (CESA) = Capital Expenditure / Sales

Total Employment (EMPL) = Total Number of Employees

Debt to Assets (LEV) = Total Debt / Total Assets

Long Term Debt to Equity (LEV2) = Long Term Debt / Equity

Dividend Payout (PAYOUT) = Cash Dividends / Net Income

Return on Assets (ROA) and Return on Equity are used as proxies for profitability.

Profitability has improved after privatisation but the results for financial year-end

2000 shows that profitability has fallen back to the level before privatisation. Net

Income Efficiency and Sales Efficiency are used as proxies for operating efficiency.

The results show that operating efficiency has definitely improved after privatisation.

However the latest result is indicating that some of the companies may be reaching

the optimum level as diminishing returns sets in. The rate of return from employing

additional staff is lower than before.

Pro-privatisation analysts expect that employment levels should fall after privatisation

as what happened in Europe. However employment levels for the companies studied

did not indicate this trend. Instead employment levels have gone up after privatisation.

Only TELEKOM recorded a significant drop in the number of employees compared

to before privatisation and that only after a long period. This is the result of political

ownership. If the state had fully divested the situation could be different. Capital

investment is expected to improve after privatisation. Capital Investment to Sales

Ratio is used for as proxy. The results are mixed. Capital investment seems to have improved for those companies privatised in the 80s (MAS, MISC, & TELEKOM) but not those in the 90s (TNB & PGAS). Leverage is also expected to improve. The proxies used are Debt to Assets Ratio and Long Term Debt to Equity Ratio. The results indicate that leverage has definitely improved after privatisation. This indicates that the proceeds from the public offer were most likely used to reduce debt. However the latest result indicate that some of the companies have started accumulating debts reaching pre-privatisation levels.

Dividend payout has improved as expected. The proxy used is Cash Dividends to Net Income Ratio. Dividend payout depends on the performance of the company and the willingness of the board to pay. The negative ratio for MAS in 2000 indicates that the board is still willing to pay dividends even though the company is making loses. They paid the dividend by drawing from the general reserve. This move benefits the shareholders in the short term but is bad for the company in the long term. It reduced the shareholders' funds. There may be a corporate governance issue here. The major shareholder may have decided to sell off his stake in the company. As such he would definitely support the recommendation for a dividend payment because he would be able to leave with more money in his hands. As the events unfolded the major shareholder, Mr Tajuddin Ramli eventually sold his shares back to the government at the end of 2000. In this case, the independent non-executive directors who are suppose to represent the other shareholders including the directors appointed by the government are not able to prevent this action which have further weakened the company.

Even if any long-term investors were to use their voting rights to oppose the measure, they would not be able to prevent it because the major shareholder would have supported it and the government will normally vote with the major shareholder. Another problem is minority shareholders do not normally exercise their voting rights because of the cost and the free rider problem. Proxy voting is not common and financial institutions that holds shares on behalf of their clients seldom exercise this voting right. Table 15(a), (b) and (c) presents the operating and financial performance of the companies studied. TNB has issued ADRs in New York. However the ADRs issued is less than 1% of total shares at 30/9/2000. The issuing of ADRs is good because it reflects the management's confidence of meeting internationally required standard. It also enhances corporate governance. The CLOB shares previously traded over the counter in Singapore also acts like the ADRs. As such the restriction placed on the trading of CLOB shares do not help corporate governance.

There is a strong link between financial performance, governance and political ownership. The governance system here is skewed towards the state. This reflects a situation where the politicians are comfortable with. Financial performance has improved immediately after privatisation but has fallen back in recent years. This reflects poor governance as much as the weak economy in general. However poor financial performance is not greatly felt in the monopolies but is evident in MAS which operates in a competitive environment. The financial performance shows that privatisation without good governance will not be sustainable. With political ownership whenever the company gets in difficulties public funds is often used to save the company. As long as there is political ownership there is always a possibility of misuse of public funds.

Companies with less political ownership tend to perform better. Examples include BAE Systems in the United Kingdom, Qantas in Australia and Volkswagenwerk in Germany. Even though there is still political links through the use of the 'Golden Share' or minority shareholdings, the political influence is only concentrated in a regulatory role. Business decisions are very much in the hands of professional management.

Table 15(a). Company operating and financial performance

Company	MAS			MISC		
	Mar 1984	Mar 1995	Mar 2000	Dec 1986	Dec 1995	Mar 2000*
Profitability						
ROA	0.06	0.00	-0.01	0.07	0.11	0.09
ROE	0.40	0.04	-0.08	0.50	0.13	0.20
Operating efficiency						
NIEFF	9537.89	7185.85	-11978.23	87952.59	166479.55	202397.90
SALEFF	121514.80	246637.79	378039.42	450765.93	733548.31	957256.42
Capital Investment						
CESA	-0.05	0.25	-0.24	-0.16	0.13	-0.06
Employment						
EMPL	10055	19381	21587	2700	3374	6856
Leverage						
LEV	0.83	0.68	0.82	0.84	0.14	0.53
LEV2	3.12	1.48	3.07	5.12	0.01	0.86
Payout						
PAYOUT	0	0.35	-0.06	0.16	0.36	0.23

* 15 months performance.

Table 15(b). Company operating and financial performance

Company	TELEKOM			TNB		
	Dec 1989	Dec 1995	Dec 2000	Aug 1991	Aug 1995	Aug 2000
Profitability						
ROA	0.05	0.09	0.03	0.03	0.05	0.03
ROE	0.14	0.14	0.05	0.08	0.09	0.09
Operating efficiency						
NIEFF	13091.54	54603.76	28448.10	21678.99	52747.72	54771.10
SALEFF	76359.62	182098.04	355629.51	160035.45	290910.25	563783.18
Capital Investment						
CESA	-0.10	0.37	-0.05	0.54	0.33	0.20
Employment						
EMPL	28041	28846	24789	23133	23565	24334
Leverage						
LEV	0.65	0.39	0.50	0.59	0.49	0.72
LEV2	1.51	0.37	0.64	1.13	0.63	1.89
Payout						
PAYOUT	0	0.13	0.32	0.07	0.21	0.12

Table 15(c). Company operating and financial performance

Company	PGAS		
	Mar 1995	Mar 1997	Mar 2000
Profitability			
ROA	0.09	0.13	0.08
ROE	0.26	0.24	0.15
Operating efficiency			
NIEFF	301338.83	N.A.	479590.72
SALEFF	650905.44	N.A.	1088360.54
Capital Investment			
CESA	0.72	-0.16	0.63
Employment			
EMPL	1396	N.A.	1703
Leverage			
LEV	0.65	0.45	0.48
LEV2	1.12	0.67	0.66
Payout			
PAYOUT	0.29	0.32	0.45

N.A. – not available

Source: Companies annual reports