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The Perspective of Corporate Governance Reformation from the Lens of Institutional Theory

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Abstract

The purpose of this conceptual paper is to address the importance of examining the link between corporate governance and foreign equity investment through the right theoretical lens. The paper focuses on the discussion of corporate governance reformation in Malaysia that gradually converged towards Anglo-American model at the pinnacle of Asian financial crisis 1997/1998. By embracing institutional theory, the actions taken by majority of organizations in Malaysia in the aftermath of the crisis are justified and the reactions of foreign investors towards the corporate governance recuperation in Malaysia's institutional corporate setting are explained. This paper also provides in depth explanation of the applied theory, which under the scope of neo-institutional theory that accentuated on legitimacy. Besides, this paper claims the relevant use of this theory with the subject discussed, thus argues the significant importance of theoretical aspects of the institutional context to the study of governance change and institutional dynamic setting in emerging country like Malaysia. In summary, the use of apt lens of theory to justify the reactions and actions taken by the actors is imperative as an essence to convey a period of momentous changes in the storyline of the governance change from the perspective of the foreign investors.

Keywords: Corporate governance, foreign equity investment, Institutional Theory, Asian Financial Crisis 1997/1998, corporate governance reformation, Malaysia.

1. INTRODUCTION

There are constant evolutions of discussion among scholars on corporate governance issues in Malaysia especially in the aftermath of the disastrous Asian Financial Crisis (AFC) that hit the country around the year 1997/1998. Following the financial crisis, corporate governance in Malaysia has been claimed to undergo a process of institutional change. This action has been translated as corporate governance reform. Since that, the issue of corporate governance remains as a topic of perennial interest and controversy. It has attracted much interest of many related parties to contribute their ideas, sharing their views as well as bringing up evidences on how to strengthen the weakness of corporate governance practice in Malaysia. The discussion, however, remains unsettled every time.

Considering the substantial amount of corporate governance issues that are beyond extend to comprehend at one time, this paper aims to focus on the discussion of theoretical issue of corporate governance reformation that gradually converged towards Anglo-American model at the pinnacle of Asian economic crisis 1997/1998. Our paper claims two theoretical contributions to the field of corporate governance. Throughout the ongoing discussion in this paper, the theoretical aspects are highlighted where the importance of the institutional context to the study of governance change is argued to be significant. Therefore, we counter the use of universal application of agency theory in the institutional dynamic setting of governance change in emerging country like

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Malaysia. In similar vein, we propose the highly and practically more relevant lens of theory to discuss the corporate governance issue in Malaysia, whom was undergoing institutional change following the financial crisis. The proposed theory is institutional theory.

This paper also argues that in examining the relationship between corporate governance variables and the selected independent variable, one must understand the root cause of its antecedents. Therefore, choosing the right lens of theory(ies) is considered integral. For this paper, in ensuring that the discussion remains align to the subject concerned, we steer the focus of this paper discussion on the issue of relationship between corporate governance variables and foreign investment in the aftermath of AFC 1997/1998. From there, the chosen theory for the selected corporate governance scenario is given its justifications.

This paper is organised into five sections. After the introduction section, the paper starts with a brief discussion of the corporate governance background in Malaysia in Section 2.0, followed by more detailed arguments of the selected theory in Section 3.0. Section 4.0 connecting the corporate governance in Malaysia with the isomorphic change and finally, Section 5.0 provides a blend of summary and conclusion for this paper.

2. CORPORATE GOVERNANCE REFORMATION IN MALAYSIA

Corporate governance in Malaysia has undergone dramatic changes in the aftermath of the AFC 1997/1998. The pressures for the reformation are derived from the exigencies of institutional forces, both inside and outside the country. There were many reasons for the substantial changes in corporate governance; one of them was to regain investors' confidence, especially foreign investment. In the aftermath of AFC 1997/98, Malaysian market has been shunned away by foreign investors. Foreign portfolio investment plummeted by 74 percent, from RM144.9 billion in 1996 to RM37.6 billion in 2001. There are many arguments attempt to explain the impetus of this foreign investors' reaction. Principally, major findings of these arguments lead to the one identical premise – the loss of confidence of local and foreign investors towards the emerging markets (Johnson et al. 2000). Therefore, highly credible theoretical explanations are required to justify the relationship between foreign investments and corporate governance practices in Malaysia, with the institutional forces and governance reformation in mind.

There are many theories which are prevalent in corporate governance study. Most of the extant literature examines corporate governance variables in relation to foreign ownership using agency theory (Chizema & Kim, 2010), whereas many others use other theory; such as resource dependence theory as their theoretical lenses (Douma et al. 2006). However, the insights from these theories are inept as Malaysia is one of the emerging economies with the different institutional backgrounds which is in contrast to developed economies (Fama & Jensen, 1983). Thus, this paper posits institutional theory to be employed as the underpinning lens as it is contended that this theory can explain the relationship between corporate governance variables and foreign investment in Malaysia. Other theories are considered less relevant to the current scope of study which is confined to examining foreign investors' investment behaviour or more specifically their reaction towards corporate governance system in Malaysian companies. The institutional background in Malaysia's unique corporate environment is a part of major consideration.

3. INSTITUTIONAL THEORY

In order to explain the institutional changes of corporate governance in Malaysia in the aftermath of the AFC 1997/1998, institutional theory is claimed to be the ideal theory to be used as an explanatory device. According to Peng (2002), the institutional framework is an element that is rarely disputed in the study of organisations and this reformation of corporate governance is largely claimed to be influenced by the institutional forces. In order to stay legitimate, the affected firms in Malaysia have to abide to these pressures. These influences are generally considered as institutional frameworks (Scott, 1995). In this light, the main and strong theory explanation is integral. Thus, this study is in a sturdy opinion that institutional theory is considered as the most applicable one.

The root-based of institutional theory is entrenched from the concepts of 'institution' and 'institutionalisation' (Meyer & Rowan, 1977). Zucker (1987) claims that by applying institutional theory it can provide comprehensive views of organization, thus, this has become a dominant theory for studying organisations (Suddaby, 2010). Institution is not only restricted to only legal and regulatory, where in a wider context, it can also be prescribed as humanly devised constraints that can determine the form of interaction between people (North, 1990). Thus, companies' policies, cultural and societal norms are also included (Aguilera & Jackson, 2003).

There are many approaches to reflect this theory (DiMaggio & Powell, 1991), as it depends on many factors and are subjected to the changes that occurred in organization. According to Greenwood and Hinings (1996), among the factors are; political, regulatory and technological complexities. In order to remain competitive and survive, the organization has no option but to embrace the changes (D'Aveni, 1994). Referring to the discussion on the institution and institutional, the insights of many scholars are depicted in the following Figure 1.0.

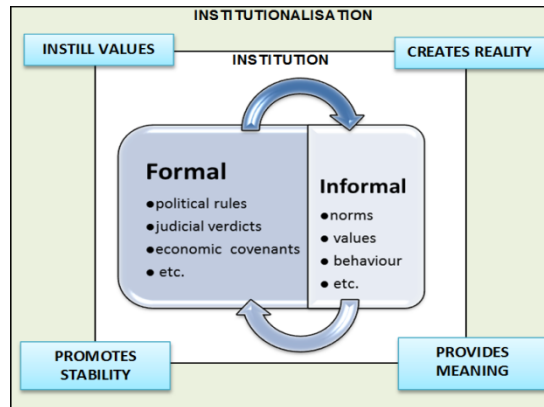


Figure 1.0. Institution and Institutionalisation – Elements and Process.

From the figure, it can be described that the aspect of the institution is claimed to be composed of formal and informal (Aguilera & Jackson, 2003) and institutionalisation can be defined from many perspectives, such as the process of creating reality (Berger & Luckmann, 1967), instilling values (Selznick, 1957), promoting stability and providing meaning (Scott, 1995).

3.1 “Old” and “New” Institutionalism

There is discrimination between ‘old’ and ‘new’ institutionalism (DiMaggio & Powell, 1991). The ‘old’ version focuses on issues such as coalitions, influence, competing values, power and informational structures (Greenwood & Hinings, 1996; Selznick, 1957), while the latter accentuated legitimacy. Thus, this study will hold the concept of the latter, which is now called the new institutional theory, or neo-institutional theory (Mizruci & Lisa, 1999). New institutionalism expands a sociological view of institutions by examining their interactions and provides justifications on how they can affect society. The legitimacy is considered as an integral aspect in an institutional environment (institutions operate in an environment that is constituted of other institutions), where each of institution can be influenced. In that kind of situation, their main goal is to survive and for that reason, not only economic success is integral but to establish legitimacy within the institutional environment is much more critical (Oliver, 1997). The legitimation in this new strand of theory can be viewed as the process of seeking acceptance by other organisations in order to sustain in business.

The action taken by the organization should be compatible with the society’s expectation (Meyer & Rowan, 1997). In particular field, there are tremendous resemblance of organizations occur that consistent with the argument by Meyer and Rowan (1977) which contend that the similarity arises as a result of institutional pressures. The pressures force organisation to take further action in order to attain legitimacy in a wider environment (Mizruci & Lisa, 1999), as the dependent on resources from their environment is vital in order for them to sustain (Pfeffer & Salancik 1978). To describe this homogenisation process, DiMaggio and Powell (1983) adopted the ecological concept of isomorphism.

According to Meyer and Rowan (1977), the concept of isomorphism is explained when organisations become similar to their environment (technically or by exchange of interdependencies, or both). Thus, for this study, this strand of organisational theory is found helpful to be used as a premise to provide reasonable justifications of foreign investors’ investment behaviour in Malaysian companies. It is critical to find sensible answers based on the right conceptual lens to the questions that are raised in this study. The questions such: (i) What are the properties of the different views held by foreign investors when making investment decisions in the Malaysian capital market compared to other capital markets? (ii) How to explain the differences? (iii) How to justify the presumed relationships? And most importantly, (iv) which theory(ies) can offer the best explanation of the process of investment decision making by foreign investors in Malaysian PLCs after the AFC 1997/1998? The theoretical progress in explaining the issues and answer the questions should be tackled wisely and judge from many angles (Powell, 1996) such as “how they matter, under what circumstance, to what extent, and in what ways”. Therefore, it is proposed an institutional theory, under the new institutionalism that focuses on the strand of sociology, which is known as New Institutional Sociology (NIS) to act as the most relevant organisation theory in responding to most of the triggered questions.

3.2 Institutional Isomorphism

Based on the NIS justification, the behaviour of organisations is influenced by the forces that exist in the wider ‘society’. In this context, Clark (1962) defines ‘society’ as a unit that comprised of institutions that interlock

comfortably for the sake of efficiency. In large argument by scholars, in order to find legitimacy, the rules that been applied should adhere to the values and norms that are accepted by society, and political influence may able to escalate the institutional legitimacy process (Meyer & Rowan, 1977). This argument is consistent with DiMaggio and Powell (1983) who defy the claim that organisations are only concern to compete for resources and customers. Legitimacy is important to organization as a sign of recognition by society, and as a gateway to access for external resources in order to sustain and compete in the market.

The result of institutional isomorphism is homogenisation, which will lessen the variation and diversification among organisations. Thus, the level of homogeneity among organisations is increasing over time. The inevitable push towards homogenisation forces the changes within the organisation to occur (DiMaggio & Powell, 1983). Since the changes are largely depends on the environment in which the organisations operate, the organisations change become isomorphic with their environment (Meyer & Rowan, 1977; Slack & Hinings, 1994). The tendency of the countries or organizations to adopt similar institutions (e.g. in this context; corporate governance structures), can be described as an isomorphism. The desire of an organisation to model himself after the other successful organisation also indicate the emergence of institutional isomorphism (DiMaggio & Powell, 1991).

In summary, there are three (3) mechanisms through which institutional isomorphic change occurs, namely coercive, mimetic and normative (DiMaggio & Powell, 1983). These mechanisms do not need to occur simultaneously; in fact, it can occur through one or in any combination of these three mechanisms (DiMaggio & Powell, 1983). However, the final result would be the changes in the organisational sphere, in terms of organisational structures, systems and activities.

3.2.1 Coercive, Mimetic and Normative Isomorphism

Coercive isomorphism stems from political force and seeks for legitimacy (DiMaggio & Powell, 1983). The pressures are exerted on the organisations by the other coercive organisations, either in a formal, informal or it can be in a both ways. The reason for the exerted organisation to abide to the pressures is because the survival factor, as they need to get support from more powerful organization (DiMaggio & Powell 1983). For example, in Malaysia, it is common for public companies to depend on government institutions as these institutions are powerful in deciding policies and determine the viability of sources to the certain organizations (Suto, 2003). These actors (i.e. dependent organisation vs coercive organisation) can also exist in other situation, such as parent company vs subsidiary company, etc. DiMaggio and Powell (1983) also claim that the higher the extent of the dependencies on the other organisation, such as on their vital resources, further strengthen the pressure to become isomorphic with the environment. The disobedience by the pressured party may detriment the organisation in many ways.

On the other hand, mimetic isomorphism results from the uncertainty that pervades organisations (DiMaggio & Powell, 1983). Organizations are very sensitive with the changes that happened surrounding them (Selznick, 1996), thus it acts as a strong pushing factor to initiate the action of imitation by referring to the other organization that is perceived to be more successful. It is also claimed that the anxiety experienced by organizations making them uncertain and they are trying to response to the changes in environment in order to solve the problem. However, the action taken is sometimes seen as more compulsive rather than rational (Selznick, 1996). Other than “uncertainty” issue, there are a few other internal factors that can contribute to the imitation process, such as ambiguous objectives, unclear solutions, less technological acumen, etc. Notwithstanding of the arguments that copying another organization may lessen the competitive advantage, Maggio and Powell (1983) contend that the imitation may increase organisational legitimacy and sustainability.

The last mechanism of institutional isomorphism is normative isomorphism. An organization is shaped by the normative pressure that embraces them (DiMaggio & Powell, 1983; Meyer & Rowan, 1977; Zucker, 1987). Normative pressure may arise from external source such as state and also internal sources such as professionalism (Zucker, 1987). The formal education received in a university and the enlargements of professional networks are the two aspects of professionalism that allows new values to be dispersed easily across organisations. A person holds these values within themselves until they enter the employment, and later they disseminate the value across organisations. This is similar to the professional bodies that have been embedded with certain values to be abided by their professional members in the circle. It is asserted that; person with similar background, will share common attributes and seem to view problems and analyse them from the same perspective. Therefore, despite of locations and nature of industry they enter for employment, they will operate in a standard working environment as they have a set of rules that which will determine the ‘yes’ and ‘no’ action as professional behaviour (Berger & Luckmann, 1967). These conditions will expedite isomorphism with the institutional environment.

4. CORPORATE GOVERNANCE AND “ISOMORPHIC CHANGES” IN MALAYSIA

Based on the overview of institutional concepts, it is instructive for this study to embrace institutional theory as the theoretical lens. In the context of Malaysia, in the aftermath of the Asian Financial Crisis (AFC) 1997/1998, the corporate governance structure has changed massively. The major players in the economic system have begun to realise the potential defect on economies of deficiencies in corporate governance. Therefore, the steps of corporate governance reformation have gradually developed by the responsible parties with clear intention of creating a better image of the country, subsequently attracting more investors, especially foreign investors. In this phase, in order to regain the confidence of investors, many institutions have come forward to propose the changes, such as the International Monetary Fund (IMF). The Malaysian government as one of the main players for instance, has also played a diligent role in ensuring that this goal could be achieved.

In addition, other factor that crucial to consider why institutional perspective is strongly linked to Malaysia's governance reformation is that, large Malaysian firms were substantially dependent on government resources (Gomez 1994; Suto 2003). There are companies in Malaysia, known as government link companies (GLCs) that are working very close to government policies. GLCs in Malaysia dominated nearly 40% of the total market capitalization in Bursa Malaysia and their relationship is reciprocal; both parties benefited from the connection which making them vulnerable if they break the connection. Aware of the critical role played by the large firms in stimulating the economy, the government of Malaysia sought to reform the corporate governance structure, which is consistent with the recommendation made by IMF in order to regain investors' confidence. As asserted by DiMaggio and Powell (1983), the forces that arise within organisation in an effort to maximise shareholders' value, has place extreme pressure on firms in search of legitimacy to imitate or adopt the governance structures of Anglo-American capitalism. This has become an indicator that a process of isomorphic change has occurred in the Malaysian institutional environment.

As a result, in order to review the existing corporate governance system and to provide recommendations for a better practice, a few formal bodies have been established and consequently, the Code on corporate governance was released in March 2000. The release of this Code has marked the significant importance of corporate governance reformation in Malaysia (Ponnu, 2008). Klapper and Love (2004) view the reformation of corporate governance as a global phenomenon while from the argument of Scott (1987); it can be seen as a pushing factor from the perspective of institutional theory. The reformation was necessary to happen at that particular time and it can be translated as a lawful need coming from society.

5. DISCUSSION AND CONCLUSION

There are vast discussions on corporate governance reformation. However, Chizema and Kim (2010) note that most of the literature on corporate governance reformation still employs agency theory as its theoretical premise. According to Fama and Jensen (1983) it is a serious flaw to use agency theory if the capital markets that are examined are not liquid, and shareholder protection is not their precedence. This argument is supported by Dacin, Goodstein and Scott (2002) as they suggest that different theoretical lens should be applied in different institutional contexts. In that case, Aguilera and Jackson (2003) as well as Buck and Shahrim (2005) have proposed institutional theory to be applied. The institutional theory is claimed as an ideal framework to obtain insights in order to analyse the antecedent of corporate governance reform while agency theory on the other hand is under-utilised as the social aspect of firms has been neglected (Aguilera & Jackson, 2003).

Likewise, it also contended by Douma et al. (2006) that institutional theory is highly likely to analyse this social issue in greater depth. Many times, this issue has been overlooked, which may flaw the justification of the existence relationship under of concern. As Malaysia has geared up to strengthen its corporate governance to regain investor confidence, a process of institutional change has occurred in the aftermath of the AFC 1997/1998, which has been translated as corporate governance reform. Thus, in this light, institutional theory is cogent to be employed as one of the dominant theories for the study of corporate governance reform when linked to any related variable.

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