

**OWNERSHIP STRUCTURE, CORPORATE GOVERNANCE AND FIRM
PERFORMANCE IN MALAYSIA**

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This research work is dedicated to my beloved family, my mother, my father, my wife, my daughter, my brothers and sisters

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ABSTRACT

Highly corporate concentrated ownership was among the significant factor that brought Malaysia into the 1997/98 financial crisis. Concentrated ownership, as agency theory states, has contributed to lower the effectiveness of corporate governance by considering the interests of majority shareholders at the expense of minorities, having the motivation and power to punish management and either appointing independent directors or sitting personally on the board to protect their interests. To overcome the problem, the MCCG, which largely followed recommendations of the United Kingdom (UK) code, was issued in 2001. However, it was argued that the same requirements of corporate governance practices in the UK code may not work effectively in a country which has a different legal system, business culture and corporate structure. Despite many studies have been conducted to examine the influence among the ownership structure, corporate governance and firm performance, the results of the previous studies are still indeterminate. Unlike many previous studies, this study aimed to examine corporate governance in Malaysia by investigating ownership structure independently of corporate governance. Ownership structure was measured by government ownership, local nominees, and foreign nominees, while corporate governance was measured by CEO's duality, number of independent directors, board size, frequency of board meetings, number of women directors and audit committee. Firm performance was measured by return on assets and earnings per share. Data on ownership structure and corporate governance were collected from companies' annual reports, while data regarding firm performance were gathered from Bloomberg database sources and Annual Reports. Data were collected from secondary sources for the period 2003 to 2013 involving 341 Malaysian Public Listed Companies selected using a purposive sampling method involving the companies that have been existed throughout the period of 2003 to 2013. The data were analyzed using descriptive statistics, correlation and panel data regression model. Results of testing the influences among ownership structure, corporate governance and firm performance are found to be mixed. For example, local nominee, CEO duality and board meeting showed weak and negative influences on return on asset while foreign nominee and independent directors had weak and positive influences on earnings per share. The same mixed results were also found between concentrated ownership and corporate governance. This study has added to the body of knowledge from a different perspective of considering ownership structure as an independent variable separated from corporate governance. Finally, the findings of this study expect to assist the relevant authorities to evaluate the present listing requirements, corporate governance practices and the current ownership structure trends in enhancing future corporate performance.

Keywords: ownership structure, corporate governance, firm performance and Malaysian listed companies.

ABSTRAK

Pemilikan korporat secara berfokus merupakan salah satu faktor utama yang membawa Malaysia ke dalam krisis kewangan pada tahun 1997/98. Pemilikan Menurut agensi teori pemilikan ini mengurangkan keberkesanan tadbir urus korporat disebabkan ianya lebih mengambil kira kepentingan pemegang saham majoriti yang mempunyai kuasa melantik kumpulan pengurusan syarikat dan pengarah bebas sama ada dengan tujuan untuk memenuhi kepentingan atau melindungi kepentingan peribadi. Bagi mengatasi masalah tersebut pada tahun 2001 kerajaan Malaysia telah mengeluarkan kod tadbir urus korporat yang berasaskan kod tadbir urus korporat United Kingdom(UK). Walau bagaimanapun penggunaan kod di UK tidak semestinya sesuai disebabkan berbezaan undang-undang, sistem korporat dan budaya di Malaysia. Walaupun pelbagai kajian yang mengkaji pengaruh struktur pemilikan, tadbir urus korporat dan prestasi firma telah dijalankan hasil kajian terdahulu masih tidak dapat membuktikan secara jelas mengenai hubungan tersebut. Berbeza dengan kajian sebelum ini, kajian ini bertujuan untuk mengkaji urustadbir korporat di Malaysia dengan mengkaji hubungan struktur pemilikan dan tadbir urus korporat. Struktur pemilikan diukur dengan tiga kaedah; pemilikan kerajaan, pemilikan tempatan, dan pemilikan secara nominee. Manakala tadbir urus korporat diukur dari aspek Ketua Pegawai Eksekutif, bilangan Pengarah Bebas, saiz Lembaga Pengarah, kekerapan Mesyuarat Lembaga Pengarah, bilangan pengarah wanita dan jawatankuasa audit. Prestasi firma diukur pula melalui melalui Pulangan ke atas aset (ROA) dan pendapatan sesaham (EPS). Menggunakan kaedah persampelan bertujuan, data telah dikumpulkan daripada sumber sekunder untuk tempoh 2003 hingga 2013 menggunakan pengkalan data Bloomberg dan laporan tahunan syarikat yang melibatkan 341 syarikat tersenarai awam Malaysia yang tersenarai untuk tempoh tersebut. Data kajian telah dianalisis dengan menggunakan keadah deskriptif, korelasi dan analisis regresi "panel data". Kajian ini telah berjaya memberi maklumat baru dari perspektif yang berbeza iaitu menggunakan struktur pemilikan sebagai pembolehubah bebas dan dipisahkan daripada tadbir urus korporat. Akhir sekali, hasil kajian ini dijangka akan membantu pihak berkuasa yang berkaitan untuk menilai keperluan penyenaaran masa ini, amalan tadbir urus korporat dan tren struktur pemilikan syarikat semasa dalam meningkatkan prestasi korporat Malaysia di masa hadapan.

Kata kunci: struktur pemilikan, tadbir urus korporat, prestasi firma dan syarikat tersenarai di Malaysia.

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LIST OF SYMBOLS AND ABBREVIATIONS

UK	–	United Kingdom
US	–	United States
CEO	–	Chief Executive Officer
ROA	–	Return on Assets
EPS	–	Earnings per Share
RM	–	Ringgit Malaysia
IMF	–	International Monetary Fund
FCCG	–	Financial Committee on Corporate Governance
OECD	–	Organization for Economic Co-Operation and Development
KLSE	–	Kuala Lumpur Stock Exchange (Bursa Malaysia)
PwC	–	PricewaterhouseCoopers
MCCG	–	Malaysian Code on Corporate Governance
NGOs	–	Non-Governmental Organizations
ADB	–	Asian Development Bank
SC	–	Securities Commission
BNM	–	Bank Negara Malaysia (National Bank of Malaysia)
MSWG	–	Minority Shareholder Watchdog Group
FSMP	–	Financial Sector Master Plan
IFRS	–	International Financial Reporting Standards
CMSA	–	Capital Markets and Services Act
EPF	–	Employees Provident Fund
IPO	–	Initial Public Offering
IPC	–	Infrastructure Project Cost
ANOVA	–	Analysis of Variance
SPSS	–	Statistical Package for Social Sciences
GOS	–	Government Ownership
LN	–	Local Nominee

FN	–	Foreign Nominee
ID	–	Independent Director
BS	–	Board Size
BM	–	Board Meeting
WD	–	Women Directors
AC	–	Audit Committee
VIF	–	Variance Inflation Factor
CLT	–	Central Limit Theorem

CHAPTER 1

INTRODUCTION

1.1 Introduction

The issues of ownership structure and corporate governance have been extensively addressed in previous research over the past two decades, particularly in developed countries such as the United Kingdom (UK), the United States (US) and Europe. In emerging markets including Malaysia, these issues have attracted the public attention since the Asian financial crisis in 1997/1998.

Sound corporate governance should play a significant role to protect shareholders, especially the minority, and to assure them of receiving a return on their investment (Abdul Samad, 2002). Corporate governance is considered a major player in any firm since the board of directors is essentially responsible for monitoring company performance (Finegold, Benson & Hecht, 2007), for protecting shareholders (Ponnu, 2008) and for monitoring the Chief Executive Officer (CEO) (Barclift, 2011). However, the roles of boards of directors nowadays are under pressure since their roles have become more challenging and include providing strategic planning and advice as well as assisting managing a firm through a crisis period (Daily, Dalton & Cannella, 2003).

In general, the separation between ownership and control is the key to the issue of corporate governance (Daily et al., 2003). The agency problem, for example, can be raised not only between shareholders and managements, but also between majority and minority shareholders, between the shareholders and creditors, and between largest shareholders and other stakeholders, including suppliers, customers and employees.

Having highly concentrated shareholders is one issue of ownership structure in most Malaysian listed companies that contributed to an ineffective corporate governance system (Krishnamurti, Sevic & Sevic, 2005; Zulkarnain, 2007). Corporate governance reforms in Malaysia began as a reaction to criticisms that Malaysia faced during the Asian crisis of 1997/98 in order to protect minority shareholders and to increase performance (Norwani, Mohamad & Chek, 2011). In addressing this issue and to better understand what has happened in the aftermath of that crisis, the current study focuses on examining the influence among ownership structure, corporate governance and firm performance of Malaysian listed companies through the period of 2003 to 2013.

1.2 Background of the Study

Unlike the situation in developed countries such as the US, the UK and Australia, Malaysian publicly listed companies are distinguished by highly concentrated ownership, extensive involvement of owners in management, cross holdings, pyramidal structure and an internal system of corporate governance (World Bank, 1999). The five largest shareholders in more than half of Malaysian listed companies in 1997 owned around 60% of the total shares (World Bank, 2005). Among the top five largest shareholders were nominee companies (45.6%), the government (17.2%) and foreign investors (1.5%) (Singam, 2003). The majority of nominee shareholders were owned by families (World Bank, 2005).

Cross holding is another way commonly used in Malaysian listed companies to achieve the highest possible control rights with low investment. A cross holding occurs when “a company down the chain of control has some shares in another company in the chain of control” (Thillainathan, 1999). The majority of cross holding companies in Malaysia have another listed company which holds at least 20% of their shareholding (Nallamuthu, 2013). Therefore, many directors of Malaysian listed companies that have a cross holding are involved in many different boards that are under the same holding companies in order to assure and protect the owners’ interests (Singam, 2003; Rachagan, 2010).

Another common issue in Malaysia regarding ownership structure is the presence of pyramidal structures. Pyramidal structures occur when the largest

shareholders of one company hold, at the same time, a majority of the shares of another company: this is a procedure that can be repeated several times. Pyramiding is a legal way for anyone to control a company without having high investments (Ng et al., 2014). In Malaysia, this situation enables ultimate owners who control the voting rights, together with strong relationships with the highest level of management, to increase the potential of achieving their interest at the expense of minority shareholders by confiscating their rights and ensuring that the firm's decisions are aligned with their (the owners') interests (Malan, Salamudin & Ahmad, 2012). The frequency of pyramid structure in Malaysian companies has been calculated to be around 39.3% (Claessens, Djankov & Lang, 2000).

In relation to corporate governance, Malaysia faced significant criticisms during the Asian financial crisis of 1997/98 due to the failure of large companies (Singam, 2003). Many financial performance ratios fell suddenly during the Asian financial crisis. Return on assets (ROA), for example, recorded a large decrease in non-financial companies from 4.71% in 1996 to -1.23% in 1998. Furthermore, earnings per share (EPS) of non-financial companies declined significantly from RM0.25 in 1996 to register a first negative indicator at RM-0.07 in 1998 (Abdul Samad, 2002). Many pointed to the weakness of corporate governance system as one of the main factors that brought Malaysia, similar to other countries, into the financial crisis and contributed to the decline of the performance indicators (World Bank, 1998; Aghevli, 1999; Das, 2000; Mitton, 2002). The failure of the internal corporate governance system in Malaysia contributed significantly to the Asian crisis (Liew, 2009).

Corporate governance in Malaysia not only emerged as a contributing factor during the Asian financial crisis 1997-98, but the crisis also drew public attention to the failure of corporate governance practices (Sawicki, 2005). The International Monetary Fund (IMF) and the World Bank rapidly called Malaysia to take major steps to strengthen the corporate governance system in all companies (Hua & Zin, 2007). As a first response, a high level financial committee on corporate governance (FCCG) under the Ministry of Finance was established in 1998 to investigate the quality of corporate governance in the corporate sector and make recommendations (Das, 2000). As a result, Malaysia has taken many steps to reform and improve corporate governance standards (Ponnu, 2008). A new code of corporate governance

was first issued in 2000 and became compulsory for all Malaysian listed companies to comply with in July 2001. Enhancing the board of directors and audit committee were the two main focuses in this code (Ponnu, 2008).

Despite these criticisms, corporate governance practices in Malaysian listed companies have significantly improved. For example, using a sample of 131 companies from 2001 to 2005, Noriza (2007) found that most companies were in line with the requirements of the Malaysian code regarding boards of directors. Abdul Wahab, How and Verhoeven (2007) examined 440 listed companies from 1999 to 2002 and revealed that that corporate governance practices in Malaysia have been significantly improved. Saad (2010) investigated the best practices of duality roles, board size and board meetings among 126 Malaysian listed companies from 1998 to 2006 and found that the majority of companies aligned with the *Bursa Malaysia (Kuala Lumpur Stock Exchange)* requirements.

In spite of these improvements, the code was revised in 2007 and again in 2012 to enhance corporate governance of the country including matters relating to boards of directors and audit committees (Securities Commission, 2007; 2012). The Malaysian government continues to monitor the corporate governance of the country.

1.3 Problem Statement

Malaysia was one of many East Asian countries that were affected by the financial crisis during the period of 1997 and 1998. This financial crisis began with a significant collapse of the Thai currency in July 1997 which influenced Malaysia in several aspects, including a currency crisis and a widespread financial crisis (Sundaram, 2006). The crisis began in Malaysia with the decline in the Malaysian currency which led foreign investors to withdraw their investments due to loss of confidence (Ponnu, 2008). As a result, the stock market in Malaysia fell sharply by approximately 79.3% from a peak of 1,271.57 points in February 1997 to low of 262.70 points on the first of September 1998 (Hua & Zin, 2007).

A high level financial committee on corporate governance was established in 1998 to investigate the quality of corporate governance in the corporate sector and make recommendations. The committee discovered that corporate governance in Malaysia was extremely weak because ownership was highly concentrated, boards of

directors may not have been as effective as required to monitor managers, the negative roles that were played by foreign and local shareholders in inhibiting corporate governance practices among Malaysian listed companies, lack of awareness of responsibilities, and finally the mechanisms for ensuring compliance, enforcement and punishment were not strong enough to be deterrent (Abdul Kadir, 1999). Others added that the failure of the corporate governance system in Malaysia could be attributed to unreliable financial reports and inadequate auditing and disclosure processes (World Bank, 1998; Mitton, 2002).

The Organization for Economic Co-operation and Development (OECD) reported that the cause of corporate governance failure in Malaysia was closely related to ownership concentration (OECD, 2004; Abdullah, 2006; Tam & Tan, 2007). The issues of concentrated ownership in Malaysia worked to lower the effectiveness of corporate governance (Zulkarnain, 2007; Htay, Salman & Shaugee, 2013). In fact, many studies discovered that ownership in Malaysia was highly concentrated in the hands of families via nominees, in order to achieve anonymity, and the government (Salim, 2006; Nor, Shariff & Ibrahim, 2010; Htay et al., 2013). Concentrated ownership in Malaysia takes the form of 67.2% of companies are owned by families, 13.4% are owned by the government, and 10.3% are widely held by financial institutions (Taufil-Mohd, 2013). However, in developed countries such as the UK and the US, the ownership is widely dispersed among a large number of shareholders, with few companies having a majority shareholder. Majority ownership by a single shareholder is unusual. It is very common for the largest shareholding to own 20% or even less (Leech, 2001).

As revealed earlier by Claessens, Djankov and Lang (1999) the agency problem in Malaysia was not, as is common in other countries, between managers and largest shareholders, but rather it was between majority and minority shareholders. The disadvantage of concentrated ownership, as agency theory states, is its contribution to the weakness of corporate governance by considering the interests of majority shareholders at the expense of minorities (Claessens & Fan, 2002; Cheung & Chan, 2004), having the motivation and power to punish management (Morck, Nakamura & Shivdasani, 2000), and either appointing independent directors or sitting personally on the board to protect their interests (Tam & Tan, 2007; Lefort & Urzúa (2008).

In Malaysia, a survey conducted by FCCG, the Kuala Lumpur Stock Exchange (KLSE) and PriceWaterhouseCoopers (PwC) in 1998 revealed that largest shareholders were sitting on the boards of the majority of Malaysian listed companies (Thillainathan, 1998). Tan and Sendjaya (2006) found that almost 30% of independent directors of Malaysian listed companies were appointed because of their direct or indirect relationships with the largest shareholders. Further, Claessens et al., (2000) found that in 1996 the top owners who own 20% of the shares involved in management in 85% of Malaysian listed companies. As a result of the extent of this phenomenon, the largest shareholders controlled and affected decision-makings of the majority of listed companies, including interference in the appointment of board members (Tam & Tan, 2007).

Several steps have been taken by the Malaysian government to reform the corporate governance system in order to enhance the protection of shareholders, especially minority shareholders, and to improve performance (Singam, 2003; Norwani et al., 2011). As a first step, the Malaysian code on corporate governance (MCCG) has been issued in July 2001 which was largely followed recommendations of the UK code (FCCG, 2000). Later in 2007 and 2012, the code had been revised to enhance the effectiveness of the board of directors and the audit committee. Among others, the Malaysian highlights the composition of the board and the importance for the independent directors to have an independent oversight function. Despite the effort to improve best governance practices in Malaysian companies, many argued whether the same requirements of corporate governance practices in the UK code can work effectively in a country which has a different legal system, business culture and corporate structure. Mainly, Malaysian business ownerships are highly concentrated and dominated by large shareholders who always have influence on the management of the firms (Haniffa & Hudaib, 2006). Due to poor enforcement of legal protection on shareholders and ineffective market discipline in Malaysia, the controlling shareholders are free to act in their own best interest rather than for the company as a whole.

Therefore, this study was designed, for a few reasons, to measure not only the influence of concentrated ownership and corporate governance on firm performance, but also to measure the influence of concentrated ownership on corporate governance practices in Malaysian firms. First, studies that have investigated the relation

between concentrated ownership and corporate governance in Malaysia are very limited in number. Second, studies that have investigated the effect of the presence of women directors on boards as an internal governance mechanism are very limited in Malaysia. This is because the Malaysia code requirement that women should constitute 30 per cent of board members by 2016 was tabled only in 2012. Third, empirical results from studies that addressed the relationships between ownership structure, corporate governance and firm performance are not yet clear. Finally, many previous studies that conducted in Malaysia investigated the relationship among ownership structure, corporate governance and firm performance on a short term basis, but this study used very large data collected from a large number of companies.

Results of this study are of significance to the relevant authorities (i.e. Bank Negara Malaysia, the Securities Commission, Bursa Malaysia and the Malaysian Institute of Corporate Governance) in aiding the development of policies suited to the Malaysian business culture. The study also provides insights into the holdings of large shareholders and assessments of the present listing requirements for Malaysian listed companies.

1.4 Research Objectives

Drawing upon the above discussion, this study was conducted to achieve the following objectives:

1. To measure the overall trends of ownership structure, corporate governance practices and firm performance trends among Malaysian listed companies.
2. To measure the influence of concentrated ownership structure on firm performance in Malaysian listed companies.
3. To measure the influence of the adoption of Malaysian code on corporate governance on firm performance in Malaysian listed companies.
4. To measure the influence of concentrated ownership structure on corporate governance practices in Malaysian listed companies.
5. To propose new remedies that can be used by relevant authorities in relation to the enhancement of Malaysian corporate governance framework.

1.5 Research Questions

Based on the above objectives, this study designed to answer the following questions:

1. What are the overall trends of ownership structure, corporate governance practices and firm performance in Malaysian listed companies?
2. How does concentrated ownership structure influence firm performance in Malaysian listed companies?
3. How does the adoption of Malaysian code on corporate governance influence firm performance in Malaysian listed companies?
4. How does concentrated ownership structure influence corporate governance practices in Malaysian listed companies?
5. What are the new proposed remedies that can be used by relevant authorities in relation to the enhancement of Malaysian corporate governance framework?

1.6 Research Hypotheses

This study adopted both null and alternative hypothesis among the model variables as follows:

Null hypothesis $H_0: \beta_1 = 0$

Alternative hypothesis $H_1: \beta_1 \neq 0$

Three main hypotheses and ten sub-hypotheses were developed for the study. All hypotheses are summarised in Table 1.1.

Table 1.1: Summary of the hypotheses

Main Hypothesis	Sub-hypothesis	Null hypothesis (H0)	Alternative Hypothesis (H1)
H1	H1a	Ownership structure has no influence on return on assets	Ownership structure has an influence on return on assets
	H1b	Ownership structure has no influence on earnings per share	Ownership structure has an influence on earnings per share
H2	H2a	Corporate governance has no influence on return on assets	Corporate governance has an influence on return on assets
	H2b	Corporate governance has no influence on earnings per share	Corporate governance has an influence on earnings per share

Table 1.1 (continued)

H3	H3a	Ownership structure has no influence on CEO duality	Ownership structure has an influence on CEO duality
	H3b	Ownership structure has no influence on independent director	Ownership structure has an influence on independent director
	H3c	Ownership structure has no influence on board size	Ownership structure has an influence on board size
	H3d	Ownership structure has no influence on board meeting	Ownership structure has an influence on board meeting
	H3e	Ownership structure has no influence on women directors	Ownership structure has an influence on women directors
	H3f	Ownership structure has no influence on audit committee	Ownership structure has an influence on audit committee

1.7 Scope of the Study

This study examined the influence of ownership structure, corporate governance and firm performance in Malaysia. Ownership structure is measured by government ownership, local nominee ownership and foreign nominee ownership. Corporate governance is measured by six variables; namely CEO duality, independent directors, board size, board meetings, women directors and audit committee. Return on asset (ROA) and earnings per share (EPS) are the two variable used to measure firm performance. The scope involved 341 companies that were listed under the *Bursa Malaysia* main market throughout the period from 2003 to 2013.

1.8 Significance of the Study

This study was conducted to add important value to the body of knowledge, practice and policy makers.

1.8.1 Body of Knowledge

This study adds a significant value to the body of knowledge since ownership structure is used in this study as an independent variable separate from corporate governance, unlike most previous studies. The significance of using ownership structure independently is that it provides new insights into the roles of ownership structure in enhancing corporate governance and firm performance. In addition, this

study used data from a large number of Malaysian listed companies for a period of 11 years, from the beginning of corporate governance reforms in Malaysia up to the time the study was conducted. Because of the large sample size and the recency of the data, the study's findings may have a higher level of generalizability.

1.8.2 Practice

Results of this study are useful for managers who are concerned with the role of ownership structure and corporate governance practices in their firms. These findings will assist managers to make appropriate decisions to increase firm performance. Managers should consider that investors can use these results to assess management's performance in managing their firms. The results of this study are also significant to financial analysts, since they will highlight ownership structures and corporate governance factors that positively contribute to increased performance.

1.8.3 Policy Makers

The Malaysian code on corporate governance, which is closely derived from a UK code, was issued early in 2000s as a reaction to criticisms made against Malaysia during the Asian crisis of 1997/98. This code is mostly aligned to the agency theory perspective in order to recapture investors' confidence, protect minority shareholders and to enhance performance. In 2007 and 2012, the code was revised to strengthen the roles and responsibilities of the audit committee and the board's effectiveness through its composition and by strengthening its independence. In spite of the significant steps that have been taken to enhance best governance practices in Malaysian firms, many researchers have questioned whether the same corporate governance system in developed countries can work effectively in a country that has a different business culture and highly concentrated share ownership, with large shareholders who may influence the firms' management..

Findings of this study provide a clear picture to *Bursa Malaysia*, the Securities Commission (SC) and *Bank Negara Malaysia* (BNM) to adopt and design policies that are more appropriate for the Malaysian business culture. The relevant authorities will benefit from the outcomes of this study since the results reflect the

influence among ownership structure, corporate governance and firm performance. This will assist policy makers in Malaysia to assess the role of present listing requirements and corporate governance practices in enhancing company performance. In addition, this study will help the relevant parties to evaluate the current ownership structure in Malaysian listed companies. Findings of this study will be an indicator to the Malaysian authorities to understand the role of agency theory in strengthening firm performance. Finally, this study may indirectly contribute to the overall development of Malaysian corporate governance.

1.9 Operational Definitions

This section provides brief definitions of the key terms that are used in this study.

1.9.1 Ownership Structure

Ownership structure refers to the number of shares that are held by insiders (management) and outsiders (investors who have no direct relationship with the firm management) (Vroom & Mccann, 2009).

1.9.2 Corporate Governance

Corporate governance is “the process and structure used to direct and manage the business and affairs of the company” (Securities Commission, 2012).

1.9.3 Firm Financial Performance

Firm performance is “a set of financial indicators which offer information on the degree of achievement of objectives and results” (Lebans & Euske, 2006).

1.9.4 Malaysian Public Listed Companies

Malaysian public listed companies refer to the public listed companies registered in Malaysia and listed on the main board of Bursa Malaysia.

1.10 Structure of the Thesis

This thesis is divided into five chapters as shown in Figure 1.1

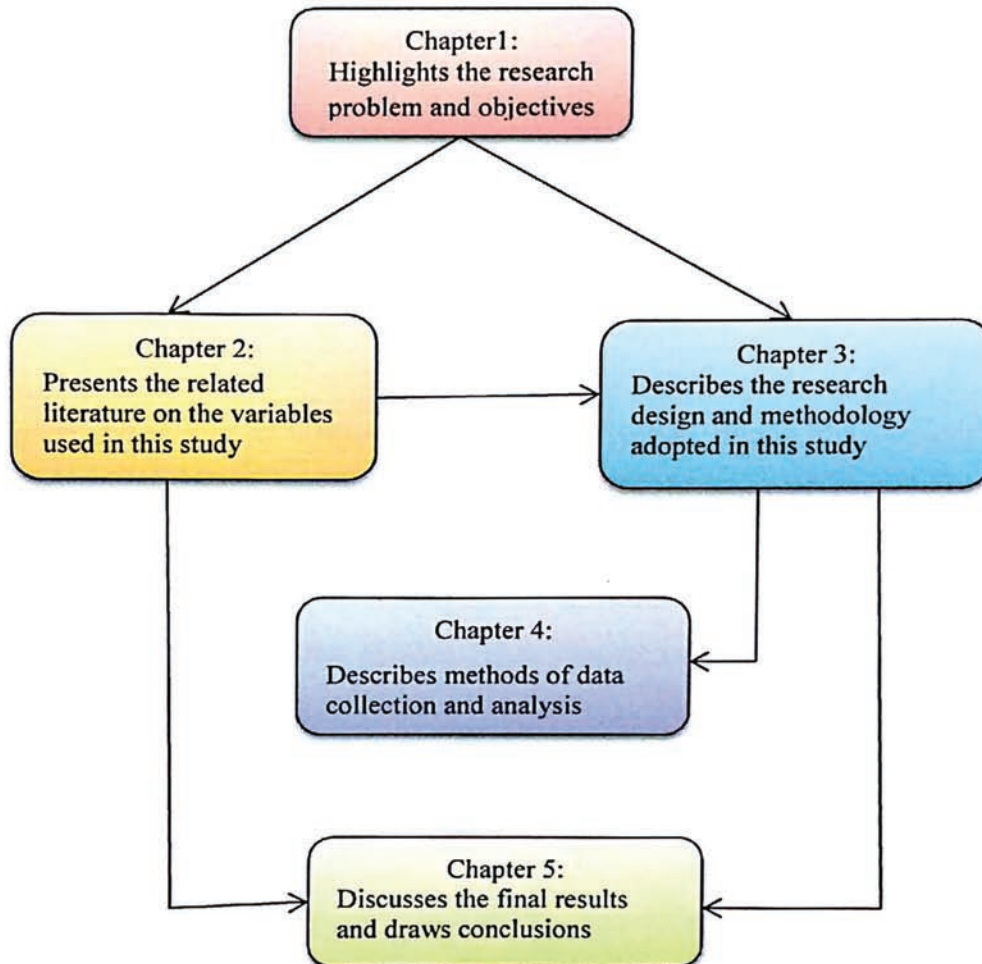


Figure 1.1: Structure of the thesis

1.11 Chapter Summary

This chapter has introduced the foundation of this study by explicating the problem statement and its significance to the body of knowledge and practice. The chapter has also provided brief definitions of the key terms used in the study. The next chapter discusses theories and literature relevant to all the variables used in this study.

CHAPTER 2

LITERATURE REVIEW

2.1 Introduction

Since the failure of corporate governance system during the Asian financial crisis 1998/97, Malaysia has recognized the significant roles of corporate governance in increasing firm performance and protecting minority shareholders from the actions of the largest shareholders. The Malaysian government has taken many steps to reform the corporate governance system. This chapter reviews related literature in order to better understand the context of the study, including reviews of a number of empirical studies that have addressed the relationship among ownership structure, corporate governance and firm performance to develop the hypotheses of this study.

2.2 Definitions of Ownership Structure and Corporate Governance

This section provides brief definitions of ownership structure and corporate governance.

2.2.1 Ownership Structure

Ownership structure refers to “the relative amount of ownership claims held by insiders (managers) and outsiders” (investors with no direct relationship with the management of the company) (Vroom & Mccann, 2009). Ownership structure is considered to be the key in determining the nature of agency theory; that is, whether the dominant conflict is between managers and shareholders, or between majority

and minority shareholders (Mang'anyi, 2011). It is suggested that better overlap between ownership and management should be guided to minimize conflicts of interest between them, and therefore result in higher firm performance (Holderness, 2009). However, the relationship between ownership, management and firm performance can be very complicated. For instance, Denis and McConnell (2001) demonstrated that management ownership of a company can act to motivate the interests of both managers and shareholders. In contrast, if their interests are not in line with each other, managers with higher ownership may have more freedom to follow their own objectives without any fear. Demsetz and Villalonga (2001) argued that directors may be placed on the boards not because they hold large numbers of shares, but because they represent the interests of the large shareholders. Such types of members may not have the same interests as management does, but rather their interests are in line with those of outside investors.

The perspective of agency theory is highly based on shareholders of the firm and their relationships with the management. Therefore, achieving higher possible performance is in part dependent on the extent of convergence of interests between managers and shareholders.

2.2.2 Corporate Governance

Corporate governance is the key to protect minority shareholders and all stakeholders in general. Cadbury (1992) earlier defined corporate governance as “the system by which companies are directed and controlled”. Demb and Neubauer (1992) defined corporate governance as “the process by which corporations are made responsive to the rights and wishes of stakeholders”. Another definition of corporate governance is provided by Turnbull (1997) who defined it as “describing all the influences affecting the institutional processes, including those for appointing the controllers and/or regulators, involved in organizing the production and sale of goods and services”. A different definition is that of Shleifer and Vishny (1997) who explained corporate governance as “dealing with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment”. Weaver, Trevino and Cochran (1999) stated that corporate governance structure can also identify the distribution of rights and responsibilities among different participants in

the corporation, such as the board, managers, shareholders and other stakeholders. More recent definitions of corporate governance are presented later in section 2.5

2.3 Theories for Relationships among Ownership Structure, Corporate Governance and Firm Performance

This section discusses the most common theories that describe relationships between ownership structure and corporate governance and their effect on increasing firm performance. These theories are Agency Theory, Stewardship Theory, Stakeholder Theory and finally Resource-based Theory. Each theory is described in some detail below.

2.3.1 Agency Theory

Agency theory is the key for researchers addressing ownership structure and corporate governance (Yusoff & Alhaji, 2012). A company, according to Fama and Jensen (1983), is assumed to be “a set of contracts among factors of production”, which include employees, customers, suppliers and creditors. Each factor works only to maximize its own self-interest and this gives rise to agency theory. Therefore, these contracts aim to encourage all parties who care about their personal interests to increase corporate value, minimize agency cost and adopt effective accounting methods (Deegan, 2004).

Berle and Means (1932) considered corporate governance to be a mechanism where a board of directors is an effective monitoring tool to reduce the problems brought about by the principal-agent relationship. Principals in this context refer to owners, while agents refer to managers (Mallin, 2004). If both the owners and managers act only to advance their own interests, agency theory is relevant. Human beings generally are self-interested and willing to achieve their interests at the expense of others. Therefore, managers and owners should have clear interests which are in line with each other to reduce the effect of agency theory (Daily et al., 2003).

However, with different levels of management and owners (majority, minority, inside and outside ownership), agency theory can be applied. The separation between ownership and control is widely considered to be the most

significant element in any discussion of agency (Fama, 1980). Jensen and Meckling (1976) pointed out that agency theory can be raised when managers and owners of companies are separated. Managers in most cases act to further their own interests at the expense of owners, which may affect companies' performance in the end. Therefore, there are many steps that can be taken to protect shareholders interests and reduce the effect of agency theory.

One way to reduce agency theory is to enhance inside ownership in a company. Jensen and Meckling (1976) suggested that increasing the number of insider shareholders can lead to better approximation of interests between managers and outside shareholders and then improve firm performance. Earnhart and Lizal (2006), for example, found when examining numbers of Czech firms from 1993 to 1998 that insider ownership had a significant positive influence on firm performance. Another study conducted by Kaserer and Moldenhauer (2008), using a sample of 648 German companies for two years (1998 and 2003), revealed that insider ownership enhanced firm performance measured by stock price performance, market-to-book ratio, and return on assets. Further, using a large sample of public listed companies from the US and Europe, Gugler, Mueller and Yurtoglu (2008) discovered that the effect of insider ownership on firm performance was highly positive. Finally, Chen, Hou and Lee (2012) examined the effect of two categories of insider ownership (managers and directors) on firm performance of Taiwanese tourist hotels. The study found that the ownership by both managers and directors had a positive and significant influence on hotel performance.

The second way to reduce agency theory is to strengthen corporate governance system (Fama, 1980; Fama & Jensen, 1983). According to the authors, the board of directors is a significant component of corporate governance which companies should consider. The major duty of the board is to monitor managers to ensure they are running their companies effectively in order to achieve a good performance. Jensen (1993) stated that a board with a majority of outside directors can play a significant role to reduce agency theory because outside directors are more independent than insider directors to monitor and ensure managers effectively run their companies. Others, including Fama (1980), Weisbach (1988), and Baysinger and Hoskisson (1990), have also contended that inside directors are often less motivated to face and monitor CEOs.

Many previous studies agree that having more independent directors is more effective in increasing firm performance than when directors are insiders. Rebeiz (2008), for example, tested the extent of the relationship between the percentage of independent directors on a board and firm performance. The finding of this study showed that a board with more independent directors had a better financial firm performance. Another study conducted by Arosa, Iturralde and Maseda (2010) that examined data from non-listed Spanish family companies in 2006, revealed that a higher percentage of independent directors on the boards had a positive and significant influence on firm performance when the firm is run by the first generation of owners. In a different part of the world, Khan and Awan (2012) examined the effect of independent directors on firm performance of 91 companies listed on the Karachi stock exchange keys-100 index. The result of this study concurred that having more independent directors on the board led to increased firm performance.

Furthermore, the presence of controlling family members on a board of directors is another factor that can demonstrate agency theory. According to Kesner and Dalton (1986, as cited in Huang and Chan, 2009), board directors who are themselves or are controlled by family members are not able to monitor and evaluate the CEO's performance effectively; thus such directors seem to be not independent. In another study, Lausten (2002) found from a sample of Danish companies, that a company controlled by family members was not able to objectively evaluate the CEO's performance. Meanwhile Jabeen, Kaleem and Ehsan (2012) used four years' data (from 2006 to 2009) of 62 non-financial companies listed on the Karachi Stock Exchange and found that the performance of family companies was lower than that of non-family companies.

Another corporate governance component which companies should consider to reduce agency theory effects is leadership structure, or CEO duality. Agency theory states that the two positions CEO and chairman of the board should be separated to enhance corporate governance and increase firm performance (Jensen, 1993). Having one individual holding the two positions can negatively influence independent directors, especially when the board is dominated by inside directors (Jensen, 1993). The main point of separating the two positions of CEO and chairman, according to the agency theory, is to ensure that power is not concentrated in a single

pair of hands to avoid the pursuit of self-interest that may occur when the two positions are held by the same person (Mallin, 2010).

Many empirical studies support the view that separating the two positions is more effective for a company. Vo (2010), for example, concluded that a corporate governance structure with two different individuals holding the two positions in a company is more effective for the fulfillment of the directors' fundamental responsibilities to oversee business operations and monitor management for the purpose of enhancing shareholder value. Another study by Syriopoulos and Tsatsaronis (2012) indicated that separating the functions of the CEO and chairman had a positive and significant effect on the performance of financial firms. However, Shukeri, Shin and Shaari, (2012) found, in using a selected random sample of 300 Malaysian listed companies for the year 2011, that there was no significant relationship between CEO duality and firm performance. Furthermore, Ujunwa, Salami and Umar (2013) concluded, by taking all companies listed on the Nigerian Stock Exchange for the period 1992-2009 for ownership-dispersed firms and 2003-2009 for ownership-concentrated firms, that CEO duality was negatively correlated with firm performance in Nigeria, regardless of the firm's ownership structure.

The conclusion is that the effects of agency theory can become apparent when owners and managers have separate points of view separated due to conflicts of interest between them. However, there are many ways to reduce agency theory and to protect shareholder interests such as increasing insider ownership, having more independent directors on the board, and separating the two positions of CEO and chairman should be separated. However, in contrast to the agency theory, the position of stewardship theory is very different, as discussed below.

2.3.2 Stewardship Theory

Unlike agency theory, the main point of stewardship theory is to discard self-interests as a factor (Donaldson & Davis, 1991 and 93, as cited in Yusoff & Alhaji, 2012). This theory holds that managers' and owners' interests are in line with each other and no conflict of interest will occur between them, since the main aim of corporate governance is to find an effective structure and mechanism to ease coordination between them (Donaldson, 1990, as cited in Pastoriza & Ariño, 2008). From the

stewardship theory perspective, managers should effectively run their firms in line with the interests of shareholders and in general increase firm performance (Donaldson, 2008).

The basics of this theory are derived from social psychology, which concentrates on the behaviour of executive managers. The stewards' behaviours generally seek to achieve higher benefits for firms that are running rather than acting on their own self-interests, as long as the main aim of steward is to accomplish the goals of the company (Davis, Schoorman & Donaldson, 1997). Unlike agency theory, this theory argues that the interests of managers and owners are in line with each other (Levrau & Van den Berghe, 2007). According to Smallman (2004), there is no need to maximize managers' interest as long as the wealth of the owners is maximized. The stewardship theory claims that when managers achieve the highest possible level of success, they will definitely benefit from their success.

Thus stewardship theory suggests that there is a strong relationship between managers and the success of organizations. Managers, in the view of stewardship theory, are able to protect and motivate not only owners' interest but also the interests of other participants in the firm through achieving higher organizational performance (Clarke, 2004). Achieving a higher level of performance, according to this theory, cannot be achieved unless the positions of CEO and chairman are combined and held by one individual person to avoid conflicts in using the power (Davis et al., 1997). From the perspective of stewardship theory, then, the dual role enhances the leadership, since there is no missing information between the CEO and the board. Brickley, Coles and Jarrell (1997) argued that the dual role has a very positive effect in terms of communication and reduces conflicts in decision-making.

The stewardship theory concentrates on structures that facilitate and empower rather than those that monitor and control. Therefore, the theory strongly advocates that the two positions of CEO and chairman should not be separated but rather should be held by one person. Furthermore, it favours a majority of inside directors on the board rather than outside or independent directors to promote corporate governance and then increase firm performance (Clarke, 2004). In Arosa et al.'s (2010) view, inside directors have more knowledge and expertise about their firms than outside or independent directors have. This is supported by the findings of Muravyev, Talavera and Weir (2014), who examined a number of UK companies

from 2002 to 2008 and found that inside directors have a strong positive effect on firm performance.

Other studies that examined the relationship between CEO duality and firm performance also concluded that there are positive and significant relationships between them. Ramdani and Witteloostuijn (2010), for example, measured the influence of CEO duality on firm performance for a sample of listed companies from Indonesia, Malaysia, South Korea and Thailand and found that the relationships between CEO duality and firm performance were positive and significant. Another study by Gill and Mathur (2011) examined the influence of CEO duality on the value of 91 Canadian manufacturing companies listed on the Toronto Stock Exchange from 2008 to 2010, and determined that the CEO positively and significantly influenced the value of Canadian manufacturing firms. The same positive result was found between CEO duality and profitability of 75 listed Canadian service companies between 2008 and 2010 (Gill & Mathur, 2011a). Finally, Wang et al. (2014) found a positive and significant effect between CEO duality and firm performance for a large sample of Chinese companies.

To conclude, stewardship theory highlights two points: first, the two positions of CEO and chairman should not be separated to avoid distributing the power between two individuals whose interests may diverge, in contrast to the recommendations of agency theory. Second, stewardship theory claims that boards with more inside directors are more beneficial than boards with a majority outside directors. Again, this contradicts the advice of agency theory, which holds that having more independent directors is beneficial to the firm.

2.3.3 Stakeholder Theory

One of the most significant criticisms facing agency theory is that it does not provide a clear view and explanation of the purpose of the company in the long term (Freeman, 1984; Freeman, Wicks & Parmar, 2004). Further, opponents contend that the scope of agency theory is limited since it considers the firm's activities from only the shareholders' side. Another alternative theory, known as stakeholder theory, believes that firms' activities should be considered from more extensive viewpoints (Freeman, 1984). According to stakeholder theory, corporate activities are not only to

service and benefit shareholders but for all other parties, including shareholders (Coleman, 2008; Shengtian, Weihui & Xiaosong, 2010). Stakeholder theory defines stakeholders as “any group or individual who can affect or is affected by the achievement of the firm’s objectives” (Freeman, 1984, p.53). Groups in the model of stakeholders as suggested by Freeman (1984) include, for example, suppliers, governments, owners, environments, customers, competitors, media and employees, and each group contributes to the success of any firm.

Later, Freeman developed a revised model of stakeholders involving five internal stakeholders and six external stakeholders (Figure 2.1). The internal stakeholders include shareholders or financiers, customers, communities, employees and suppliers, while the external stakeholders include media, governments, environmentalists, non-governmental organizations (NGOs) and critics (Fassin, 2008).

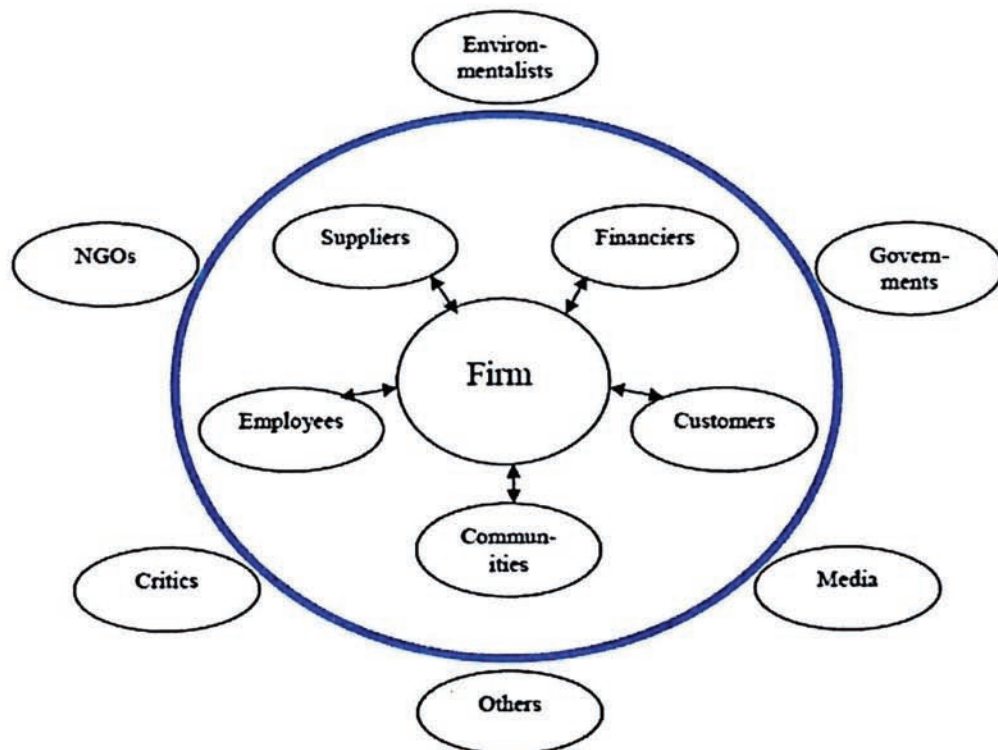


Figure 2.1: Freeman’s revised version of the stakeholder model
(Fassin 2008, p.115)

Stakeholder theory claims that firms should be run in an effective way to bridge the gap between the conflicting interests of the different groups of stakeholders (Freeman et al., 2004). Thus, the purpose of the firm and the management are the two central elements in stakeholder theory (Freeman, 1994). Since the purpose of the firm is to achieve the highest performance, managers are responsible to run their firm effectively to benefit themselves and all other stakeholders. However, stakeholder theory raises questions about managers and their relationships with other stakeholders (Freeman et al., 2004). Managers must build a good relationship, encouraging their stakeholders and creating communities for individuals who are interested to participate in raising the firm performance (Boatright, 2006). Shareholders are clearly one of the most important elements and profits are the key points of the firm activities, but the concept of profits is seen as a result rather than a way to fulfil the firm's value (Branco & Rodrigues, 2007).

To conclude, stakeholder theory criticised agency theory for its short term perspective of the purpose of the company. Achieving the firm objectives in stakeholder theory not only benefits shareholders but also other groups or individuals who contribute to achieving the firm's objectives.

2.3.4 Resource-Based Theory

The main proposition in this theory is the necessity to link firms with outside resources to survive. Firms are seen as being dependent on their outside resources and the theory suggests that a firm's competitive advantage is based on its ability to obtain the necessary resources, which may be either difficult or expensive to obtain (Barney, 1991). Successful firms have internal governance tools that are able to make outside resources available (Lawrence & Lorsch, 1967, as cited in Wong & Bajuri, 2013). Pfeffer and Salancik (1978, as cited in Marimuthu & Kolandaisamy, 2009), claimed that board size and board composition in any firm are significant tools to achieve this. Based on resource-based theory, having a large sized board is important to achieve resources beneficial to the firm (Hillman, Cannella & Paetzold, 2000). Further, boards of directors are also perceived as important resources to bring valuable external resources for the firm to promote its performance (Hillman et al., 2000; Pfeffer & Salancik, 1978). Resource-based theory believes that the directors

are the main sources to bring knowledge, skills, information and contacts, among other benefits (Hillman & Dalziel, 2003).

Hillman et al. (2000) claimed that boards with more independent directors may help to lessen the transactional costs connected with the company's outer linkages. Many researchers have used resource-based theory to illustrate that outside directors on boards are useful to obtain external resource requirements for their firms. For example, Pfeffer (1972, as cited in Oba, Tigrel & Sener (2014), indicated that independent directors were significant in providing financial resources and the regulatory environment required by the firms. Supporting this, Carpenter and Westphal (2001) concluded that independent directors, with their external networks, assisted the firms to link with outside resources. Furthermore, Westphal and Stern (2007) found that, in many cases, the independent directors of large firms held top management positions in other companies; therefore, with their expertise they were able to make valuable contributions to decision making. Hillman et al. (2000), however, concluded that the resource requirements of a firm may be modified in response to changes in its business circumstances; thus the firm requires outside directors on the board with expertise and networks in line with its activities.

To sum up, resource-based theory encourages firms to link with valuable external resources to enhance their performance. To do so, firms should include a large number of directors on their boards, the majority of whom should be independent.

Table 2.1 summarizes the main points of the theories that have been discussed.

Table 2.1: Summary of the theories

Theory	Main point
Agency theory	CEO and chairman should be separated, with more inside ownership and independent directors on the board.
Stewardship theory	CEO and chairman should not be separated with more inside directors on the board.
Stakeholder theory	Firms' activities are not only to benefit shareholders but for all groups and individuals who contribute to enhanced performance.
Resource-based theory	Large boards with more outside directors are needed to access external resources that are important for the firms to survive.

As summarized in Table 2.1, each theory has its own perspective regarding the value of ownership, management and the performance of the firms. Agency theory and resource-based theory, for example, both believe that having more independent directors on the boards is highly beneficial to the firms, although for different reasons. Agency theory believes that having more independent directors is to monitor the CEOs in order to protect the owners' interests and increase the performance in general, while resource-based theory considers that more independent directors are useful to link the firms with the important external resources that are necessary to improve performance. It is, perhaps, significant that Bursa Malaysia requires all listed companies to include at least two independent directors or a minimum of one-third of the board. However, stewardship theory is in conflict with agency theory over the perspective of protecting the owners' interests. While agency theory advocates separating the two positions of CEO and chairman to reduce conflicts of interests between managers and owners, stewardship theory recommends that the two positions should be held by the same person. Thus *Bursa Malaysia* is in agreement with agency theory on this matter. In relation to board size, the suggestion of resource-based theory is to have large boards with many members as an aid to increasing performance. However, the requirement for Malaysian listed companies is that the size should not to be extremely small or extremely large. Finally, the perspective of stakeholder theory is that a firm's activities are not only for the benefit of shareholders but for any group, including shareholders, that works to enhance the company's performance.

The following sections discuss in more detail the variables that are included in the model used in the present study, starting with ownership structure and followed by corporate governance and then firm performance.

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