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CORPORATE GOVERNANCE MECHANISMS
AND EXTENT OF DISCLOSURE:
ANALYSIS OF MAIN BOARD AND SECOND
BOARD COMPANIES IN MALAYSIA

BY

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INTERNATIONAL ISLAMIC UNIVERSITY
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ABSTRACT

Recently, there has been increased attention given to the corporate governance disclosure after the East Asian economies collapsed in the second half of 1997. This study examines the relationship between the corporate governance mechanisms and the extent of disclosure for the main board and second board of listed companies in the year 2002 and 2006. There are two research questions that would like to be highlighted: Firstly, the issue of the level of corporate governance disclosure by main board and second board companies. Secondly, the issue of how corporate governance mechanisms affect companies' disclosure between main board and second board companies. According to the agency theory context, several corporate governance characteristics in a firm, for instance, board composition, dominant personalities and the existence of the audit committees on the board, can affect the effectiveness of the board of directors' monitoring role, hence reduce the agency cost. Regression analysis was conducted to determine the association between corporate governance mechanisms and the extent of disclosure level in Malaysian corporate sector practices. Four corporate governance variables are examined in this study, which are: (i) the proportion of independent non-executive directors, (ii) the proportion of independent members of audit committee, (iii) the practice of separate CEO and chairman of the board, and (iv) the percentage of family members on the board. While size, leverage and profitability are employed as control variables. The findings provide evidence that the percentage of family members sit on the board has negative significant effect on the extent of disclosure, whilst the remaining of the corporate governance variables fail to show the significant influences on the corporate governance disclosures provided in the annual reports of Malaysian listed companies. The contribution of the study attempts to extend and fill the gap in literature as well as providing insight for standard setters especially the MCCG and Bursa Malaysia listing requirements.

ملخص البحث

كان هناك اهتمام متزايد مؤخراً، أُعطى للإفصاح عن الإجراءات الإدارية والرقابية الحاكمة للشركات خاصة بعد إنهيار إقتصاديات دول شرق آسيا في النصف الثاني من عام 1997. تهدف هذه الدراسة إلى إختبار العلاقة بين آلية الإجراءات الإدارية والرقابية الحاكمة، ومدى الإفصاح لشركات الفئة الأولى والثانية المسجلة في سوق الأوراق المالية الماليزية للعام 2002 و 2006. هناك سؤالان يريد البحث إبرازهما. أولاً، قضية مستوى الإفصاح عن الإجراءات الإدارية والرقابية الحاكمة لشركات الفئة الأولى والثانية. ثانياً، قضية كيفية تأثير آلية الإجراءات الإدارية والرقابية الحاكمة على الإفصاح بين شركات الفئة الأولى والثانية. بناء على نظرية الوكالة، هناك عدة سمات أو خصائص للإجراءات الإدارية والرقابية الحاكمة للشركات (على سبيل المثال، تركيبة مجلس الإدارة، الشخصيات المهيمنة، و وجود لجان مراجعة في المجلس) ممكن أن تؤثر على فاعلية دور مراقبة مجلس الإدارة، ومن ثمّ تخفيض تكلفة الوكالة. لقد تم استخدام طريقة تحليل الانحدار متعدد العوامل في التحليل الإحصائي من أجل تحديد علاقة الارتباط بين آلية الإجراءات الإدارية، والرقابية الحاكمة للشركات، ومدى الإفصاح المطبق لدى قطاع الشركات الماليزية. لقد تم إختبار أربعة متغيرات مستقلة للإجراءات الإدارية والرقابية الحاكمة للشركات في هذه الدراسة، تمثلت في: (أ) نسبة المديرين غير التنفيذيين المستقلين في مجلس الإدارة، (ب) نسبة أعضاء لجنة المراجعة المستقلون في مجلس الإدارة، (ج) تطبيق ممارسة الفصل بين سلطة المدير التنفيذي ورئيس مجلس الإدارة، و(د) نسبة أعضاء العائلة (المالكة) في مجلس الإدارة. في حين تم إختبار متغيرات حجم الشركة، السيولة، والربحية كمتغيرات سيطرة أو تحكم. وقد أظهرت النتائج أن نسبة أعضاء العائلة في مجلس الإدارة له تأثير سلبي مهم على مدى الإفصاح، بينما بقية متغيرات الإجراءات الإدارية والرقابية الحاكمة للشركات لم تظهر أيّ تأثير هام على الإفصاح في التقارير المالية السنوية للشركات الماليزية المسجلة في سوق الأوراق المالية. هذا وتمثلت مساهمة الدراسة في محاولة تمديد وسد الفراغ أو النقص في الدراسات أو الأبحاث في هذا المجال، بالإضافة إلى إعطاء روى لواقعي أو صانعي المعايير، وخاصة التشريع الماليزي للإجراءات الإدارية، والرقابية الحاكمة للشركات، و أيضاً متطلبات التسجيل في سوق الأوراق المالية الماليزية.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science in Accounting.

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DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

Wan Izyani Adilah Binti Wan Mohamad

Signature

Date

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LIST OF ABBREVIATIONS

e.g.	for example
i.e.	that is
IUM	International Islamic University Malaysia
UK	United Kingdom
US	United State of America
vs.	versus, against
CEO	Chief Executive Officer
CFO	Chief Financial Officer
KLSE	Kuala Lumpur Stock Exchange
RLR	Revamped Listing Requirements
MCCG	Malaysian Code on Corporate Governance
MICG	Malaysian Institute of Corporate Governance
ROE	Return on Equity
ROI	Return on Investment
SOX	Sarbanes-Oxley Act
VIF	Variation Inflation Factors
et al.	(<i>et alia</i>); and others
NED	Non-executive director
p.	Page
Sig.	Significant

CHAPTER 1

BACKGROUND OF THE STUDY

1.1 INTRODUCTION

Corporate governance is defined as “*the system by which companies are directed and controlled*” (Cadbury Committee Report, 1992, p. 4). In the Malaysian context, the Finance Committee Report (2001) defines corporate governance as, “*the process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporation accountability with the ultimate objective of realizing long term shareholder value, whilst taking into account the interests of other stakeholders.*”

According to Gillan (2005), corporate governance is defined based on one’s view of the world, as such it will vary among researchers. However, he claims that researchers often view corporate governance mechanisms from one of the two perspectives that are internal perspective (i.e. management and board of director) or external perspective (i.e. shareholders). Both perspectives will involve an assessment of the international and local regulatory frameworks, whereby not only on their effectiveness but also on how best they should be applied. As such, there is a vital distinction between owners of capital (shareholders) and managers of the business of the companies (directors), whereby the legal obligation of directors is to report and disclose to shareholders according to the requirement of the Companies Act, 1965.

Regardless of corporate governance definition used, the objectives of corporate governance are to enhance business prosperity as well as accountability (Nik Ramlah, 2001). According to Nik Ramlah (2001), in order to enhance business prosperity,

corporate governance cannot be dictated by law since it involves the function of people, teamwork, leadership, enterprise and experience. Meanwhile, enhancing accountability requires rules and regulators; and providing this is the duty of directors to shareholders as prescribed by law. This happens because the regulation will require greater disclosure of accounting policies (Dewing and Russell, 1997) to avoid any manipulation of accounting numbers. Therefore, it requires policy makers to develop effective regulation frameworks in order to enhance good governance practices of listed companies. Consequently, this accountability concept should guarantee that there is no such malaise exists in the company like fraud and material misstatement.

In view of corporate governance practices, the company's director, management and auditor should perform their professional duties in line with the objective of satisfying the needs of the shareholders. However, the call for efforts in enhancing corporate governance is never completed since corporate governance involves moral hazard and agency problems. The latter are created when the shareholders (principals) hire managers (agents) to make decisions that are in the best interests of the shareholders. According to Jensen (1994), "*these theoretical postulations continue that in general people are self-interested and will therefore have conflicts of interest in any cooperative endeavours.*" However, we can reduce the degree of those problems if we have an effective system or mechanism to prevent it. Thus, in Malaysian scenario, according to Rashidah and Roszaini (2005), the introduction of the Malaysian Code of Corporate Governance (MCCG) in 1999 is seen as a pertinent step towards better corporate governance practices of listed companies.

The development of corporate governance in Malaysia has been introduced by the MCCG (the Code) committee which comprises of the Finance Committee on Corporate Governance (FCCG), Capital Market Master Plan (CMP) by Securities

Commission and Financial Sector Master Plan (FSMP) by Bank Negara Malaysia on the financial sector. Efforts to have a sound standard of corporate governance in Malaysia are an endless journey. In welcoming address by Abdul Kadir¹ at the seminar on corporate governance (1999), he said, “*the efforts to enhance standards of Corporate Governance in Malaysia have been an on-going one.*”

The Code provides guidelines on the principles and best practices in corporate governance at board of listed companies. According to Y.B. Dato’ Mustafa Mohamad,² the aims of the recommendations in the Code are (i) to improve board composition, and (ii) to increase the efficiency and accountability of boards. These are to ensure that the decision making processes are not only independent but also the composition of the board.

The Code was introduced in March 2000 and Bursa Malaysia Revamped Listing Requirement in January 2001 has drawn attention to the importance of corporate governance and disclosure requirements to public listed companies to comply with ever since. And now, it should give the board of directors a clear picture of their responsibilities to shareholders in particular and stakeholders in general. It can be seen from the requirements on appointment of the majority of independent non-executive directors on the board and the establishment of an audit committee comprising of at least three members of whom a majority is independent directors to strengthen capital market, boost investors’ confidence and improve the credibility and accountability of financial information produced by listed companies (Rashidah and Fairuzana Haneem, 2006, p.784).

¹ Abdul Kadir, A. 25 March 1999. Securities Commission. Seminar on Corporate Governance: Towards good corporate governance. Legend Hotel, Kuala Lumpur. He was a chairman of Securities Commission at that time.

² Seminar on corporate governance: Towards good corporate governance. 25 March 1999. Legend Hotel, Kuala Lumpur. At that time, he was a Second Finance Minister, Ministry of Finance in Malaysia.

The Code has two main parts which becomes the main source and guidelines for the corporate governance practices. In fact, it is a set of principles and best practices recommended for good corporate governance. Part one sets out broad principles of good governance in Malaysia for public listed companies to disclose. These principles include the recommendations for directors, directors' remuneration, shareholders and, accountability and audit.

Part two of the Code sets out best practices for public listed companies to assist the companies in designing their approach to corporate governance. The recommendations and guidelines in the proposed Code highlight four important areas that are principle, best practices, exhortations to other participants and, explanatory notes and “*mere best practices*.” The summary of the Code is presented in the following Table 1.

Table 1
A summary of Malaysian Code of Corporate Governance³

TYPES OF AREAS	OBJECTIVE
Principles (Part 1)	To provide flexibility and common sense in its application, this is subject to the circumstances of each corporation. Compliance with these guidelines is mandatory.
Best practices (Part 2)	A set guideline of practices for the company in designing their approach to corporate governance. While compliance with these guidelines is not mandatory.
Exhortations to other participants (Part 3)	Merely helpful tips to investors and auditors to enhance their role in corporate governance since no disclosure is required if companies do not follow them. These are totally voluntary.
Explanatory notes and “ <i>mere best practices</i> ” (Part 4)	Providing explanatory notes set out to the principles (Part 1), best practices (Part 2) and exhortations to other participants (Part 3).

All listed companies by virtue of paragraph 15.26 of the Bursa Malaysia⁴ Listing Requirements are required to include in their annual report a narrative statement of

³ Paragraph 3, MCCG, 2001, p. 7.

how they have applied the principles set out in Part 1 and the extent to which they have complied with the best practices set out in Part 2 of the Code. In addition, company should provide reason(s) for any non-compliance to the Code in their annual report as well. Referring to the Table 1 above, we can see that the Code provides detailed guidelines for listed companies to follow and has a sound corporate governance framework. Therefore, the Code looks at the need to establish sound corporate governance practices by not only making it voluntary but also as mandatory disclosures, which need to be disclosed in the companies' annual reports. This is to secure sufficient disclosure so that investors and other stakeholders can assess companies' performance and governance practices, thus react in an informed way.

1.2 MOTIVATIONS OF THE STUDY

Failure in corporate governance does not only occur in Malaysia, such a classical example like Malaysian Airlines System (Gan, 2003), but also globally such as the failure of Enron and WorldCom. The collapse of well-established and high profile companies like Enron and WorldCom is one fine example how most of corporate governances are at stake nowadays. These corporate failures might have arisen due to the lack of transparency from the financial reporting system as well as inefficiency of corporate governance.

Besides, Asian financial crisis in 1997-1998 has shown the inefficiency of corporate governance and transparency (Ho and Wong, 2001). Therefore, the introduction of MCCG in 2000 by FCCG is to observe and establish a sound corporate governance framework. The recommendations in the Code have become mandatory for all public listed companies to comply, with effective from June 2001 (Mak and Li,

⁴ Formerly known as Kuala Lumpur Stock Exchange (KLSE).

2001). The Code highlights the importance of strengthening corporate governance practices on public listed companies in Malaysia. Therefore, the researcher is motivated to analyze the level of corporate governance disclosures on main board as well as second board companies since the Code is applicable to all listed companies.

The problems that we had encountered during Asian financial crisis in 1997-1998 have weakened the quality and integrity of financial reporting. This shows to us the low quality of corporate governance mechanisms as well as the disclosures. Consequently, this low quality has called for greater attention especially for regulators and business community to overcome those problems. According to Imhoff Jr. (2003, p. 8), *“accounting and auditing are only components of the broader system of corporate governance and cannot be ‘fixed’ in any lasting way without substantive changes in the overall governance process.”* He also claims that corporate governance should be given more priority than others, thus it gives another motivation for researcher to study the effect of corporate governance mechanisms on companies’ disclosure between main board and second board companies. However, the researcher expects that the effect of corporate governance mechanisms on corporate governance disclosure is different between the main board and second board companies as the nature of both listed companies are different.

Prior literature in Malaysian context focuses more on studying the relationship between corporate governance mechanisms and corporate performance (e.g. Rashidah and Roszaini, 2005; Rashidah and Fairuzana Haneem, 2006), corporate governance code or corporate law reform (e.g. Ow-Yong and Guan, 2000; Hee, 2003) and impact of culture, corporate governance and disclosure on corporate reporting (Haniffa and Cooke, 2002; Haniffa and Cooke, 2005). Due to the gap of the study on corporate governance in Malaysia, especially in corporate governance disclosure, the researcher

is motivated to study in this area which focusing on corporate governance mechanisms and disclosure of main board and second board listed companies. The researcher attempts to fill the gap in literature in Malaysia studying by empirically the disclosure of corporate governance statements in companies' annual reports, specifically in the Malaysian context.

1.3 RESEARCH OBJECTIVES AND RESEARCH QUESTIONS

There are a limited number of studies conducted concerning corporate governance mechanisms and corporate governance disclosure practices in Malaysia scenario. Due to that, this study tries to examine the association between corporate governance mechanisms and the extent of disclosures in the annual reports. Besides, the researcher has not found any studies concerning the relationship between corporate governance mechanisms and disclosure particularly to main board and second board of listed companies in Bursa Malaysia. Referring to this, there are four main objectives of this study. They are:

- i. To investigate to what extent the public listed companies (i.e. main board and second board companies) produce corporate governance disclosure.
- ii. To examine the effect of corporate governance mechanisms on the extent of corporate governance disclosures.
- iii. To test whether there is any significant difference on the influence of corporate governance mechanisms on corporate governance disclosures between main board and second board listed companies.
- iv. To provide recommendation or suggestion to standard setter in order to improve corporate governance disclosure.

From the above objectives, the researcher derives three main research questions. The research questions are as follows:

- i. To what extent do main board and second board companies produce corporate governance disclosure?
- ii. Which corporate governance mechanism leads to better corporate governance disclosure?
- iii. Is there any significant difference on the effect of corporate governance mechanisms on corporate governance disclosure between main board and second board listed companies?

1.4 SIGNIFICANCE OF THE STUDY

There are at least three significant aspects of this study. Firstly, this empirical study reviews companies' corporate governance statements to determine the extent of corporate governance disclosure; to what extent they have complied with the Code of corporate governance for the main board and second board companies in Bursa Malaysia. This is because the Bursa Malaysia requirements apply to all listed companies. Thus, the researcher believes that it is important to study the second board companies as well since most of the previous studies only focused on main board or large companies. In addition, the issue of corporate governance is not only limited to large companies.

Secondly, this study will analyze the effect of corporate governance mechanism on corporate governance disclosures. Subsequently, the researcher will test if there is any significant difference on such effect between main board and second board companies. If the results show a significant difference between both boards, hence it might suggest that having one blanket code for both boards is not

applicable. Besides, this study will explain to what extent corporate governance mechanism can assist companies to have better disclosures in their annual reports. Thus, the findings of this empirical investigation might be demanded by the investors, particularly for their decision making process in assessing investment; and also to other stakeholders, generally like depositors, employees, and users of annual reports. Finally, this study provides recommendations for our Malaysian standard setters to improve the mandatory corporate governance disclosures or guidelines of best practices for the listed companies. These recommendations might provide additional inputs to the policy makers like Bursa Malaysia in regulating effective rules and regulations to public listed companies. This is important since it brings protection to investor's need and to avoid any wrongdoing and abuse of capital provided by the investor. As such, the study attempts to extend and fill the gap in literature in this area by providing insight in Malaysian scenario. It is also hoped that this study will provide evidence that corporate governance mechanisms are vital for companies towards transparency and better extent of disclosure.

1.5 OUTLINE OF THE STUDY

This study consists of six chapters including this chapter. Chapter One provides a general idea of the study, covering the background, motivation, research objectives and significance of the study. It is followed with a discussion on the importance of corporate governance as well as transparency and disclosure in Chapter Two. The differences between main board and second board companies of Bursa Malaysia are discussed in this chapter too. Chapter Three reviews the previous studies particularly on corporate governance mechanisms, disclosures and agency theory. Subsequently, the Chapter Four will focus on the research methodology, which discusses the

research issues, hypotheses development, sample selection, data collection and data analysis procedure. The discussion and analysis of findings are explained in Chapter Five. Finally, summary and conclusion of the study will be covered in Chapter Six.

CHAPTER 2

CORPORATE GOVERNANCE – AN OVERVIEW

2.1 INTRODUCTION

This chapter explains the importance of corporate governance mechanism and the relationship between corporate governance disclosures and is structured as follows: Firstly, it covers a discussion on why corporate governance is important and what are the mechanisms to make it more efficient. Secondly, this chapter also explains the significance of transparency and disclosure in corporate governance and the role they play in assuring depositors, creditors and shareholders that they will respond in an informed way. Thirdly, this chapter looks at the structure of main board and second board on Bursa Malaysia, requirements of each of them and the differences between both boards. Lastly, the conclusion of the chapter is presented.

2.2 WHY CORPORATE GOVERNANCE IS IMPORTANT?

A major concern of corporate governance is to reduce conflicts between directors or managers of the company and the other stakeholders such as shareholders in particular. Directors normally tend to take decision based on their interest at the expense of shareholders in pursuing their interests and goals. Furthermore, according to agency theory, information asymmetry happens when management (i.e. agents) has the competitive advantage of information within the company over that of the owners (i.e. principals) (Arnold and deLange, 2004, p. 753). Thus, the directors are in a position to control or manipulate the information that is provided to the stakeholders