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GOVERNANCE MECHANISMS AND CORPORATE PERFORMANCE IN MALAYSIAN GOVERNMENT-LINKED COMPANIES

BY

SITI JESLYN BINTI HASAN

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SITI JESLYN BINTI HASAN

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ABSTRACT

Corporate performance is not a trivial issue as it creates a centre of attention to those outside the corporate world as well as those inside. Aggravated by corporate collapse and malfeasance of even large corporations such as Enron and WorldCom, many people are now searching for the remedies to not only boost firm performance but at least to secure it. The emphasis on corporate governance may be one of the best choices available and this study basically attempts to provide empirical supports to this notion. Enthused by the escalating focus from the Malaysian government towards a group of government-linked companies (GLCs), this study opts to examine the governance mechanisms used in the companies vis-à-vis their performance. GLCs are perceived as major catalysts of national economic growth and account for approximately 40 percent of the Composite Index. Yet, many believe that GLCs fail to live up to expectations and their corporate governance has since been under scrutiny. A transformation manual has been released in 2005 which has, among others, the objective to reinforce corporate governance of GLCs. Parallel to this initiative, this study formulates two objectives; (1) to examine the governance mechanisms (i.e. leadership structure, board size, independent non-executive directors and managerial stock ownership) in GLCs and their relationship to performance; and (2) to analyse the substitution effect among the mechanisms on firm performance. The performance measures used here are return on assets (ROA) and Tobin's Q. Using regression analysis, there are two significant results which are obtained with regards to 50 GLCs in the sample. First, it is evident that board size between 6 and 10 members, as proposed in the GLCs restructuring plan, positively affects firm performance. Second, there is initial support to the idea that governance mechanisms may substitute each other in enhancing firm performance. Thus, these results suggest that the steps taken by the government to strengthen corporate governance of GLCs are not groundless.

ملخص البحث

إن الأداء ا اص بالشركة لا يعد أمر عادياً أو ثانويا، وإ ا هو ط إهتمام الأشخاص من داخل الشركة، بالإضافة إ الأشخاص من خارج الشركة. ومـع تفاقم الوضع بالا يار، و سؤ الأداء لك ى شركات ا سا ة مثل: شركة (إنرون)، وشركة (ورلدكوم)، أصبح الآن الكث من الناس لا يبحثون فقط عن إنعاش أو تعزيز أداء الشركة، بل إ ايتها. إن التشديد على إجراءات الإدارة والرقابة ا اكمة للشركات يعتـ واحد من ا يارات ا تاحة، وعلى هذا الأساس فإن هذه الدراسة اول توف دعم عملي أو ري ذه الفكرة. ومع الإهتمام ا تزايد من قبل ا كومة ا اليزية با اه شركات ا سا ة ا ملوكة من قبلها (الشركات ا اصة ال ا علاقة با كومة)، فإن هذه الدراسة أُختـ ت من أجل إختبار آلية إجراءات الإدارة والرقابة ا اكمة ا ستخدمة هذه الشركات مقابل أدائها. وتعتـ الشركات ا كومية ا فز الرئيس و الاقتصاد الوط ، و ا يقدر وا 40% من ا ؤشر ا ركب. ومع ذلك، فإن الكث ون مازالوا يعتقدون أن هذه الشركات أخفقت ا ياة قتضى التوقعات، ومنذ ذلك ا فإن إجراءات الإدارة والرقابة ا اكمة ا خضعت للفحص والتدقيق. و عام 2005 صدر الدليل ا عدل ذه الإجراءات والذي يتضمن من بـ أهدافه، دعم وتعزيز إجراءات الإدارة والرقابة ا اكمة ذه الشركات. و اشياً مع هذه ا بادره، فإن هذه الدراسة تضمنت هدفان: (1) دراسة أو اختبار آلية إجراءات الإدارة والرقابة ا اكمة (متمثله هيكلية القيادة، حجم لس الإدارة، ا ديرين غ التنفيذي ا ستقل ، وملكية الأسهم الإدارية) هذه الشركات و علاقتها بالأداء، و (2) ليل الأثر الاستبدا بـ آلية الإجراءات على أداء الشركة. ومن ضمن مقاييس الأداء ال استخدمت هذه الدراسة، مقياس العائد على الاصول (أر أو أيه) و مقياس (توبينس كيو). وباستخدام طريقة ليل الإ دار التحليل الاحصائي للعينة ا كونة من 50 شركة حكومية، التوصل إ نتيجتـ هامتـ ؛ أولاً، هنالك دليل على أن حجم لس الإدارة ا كون من 6-10 أعضاء كما هو مقترح ا طة ا عدلة ذه الشركات، يؤثر إ ابياً على أداء الشركة. ثانياً، هناك تأييد ابتدائي للرأى القائل إن آلية الإجراءات الإدارية والرقابية ا اكمة تمل أن تؤثر بالتبادل فيما بينها تعزيز أداء الشركة. وعلية، فإن هذه النتائج تقترح ذلك: إن ا طوات ال قامت ا ا كومة من أجل تقوية الإجراءات الإدارية والرقابية ا اكمة للشركات ا كومة ا أساس من الصحة.

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.

………………………………………
Hafiz-Majdi Abdul Rashid
Supervisor

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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Examiner

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………………………………………
Jamil Osman
Dean, Kulliyyah of Economics
and Management Sciences

DECLARATION PAGE

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.

Siti Jeslyn binti Hasan

Signature …………………………………. Date ………………

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CONTENTS

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LIST OF ABBREVIATIONS

CEO	chief executive officer
CLSA	Credit Lyonnais Securities Asia
e.g.	*(exempligratia)*; for example
EMU	European Monetary Union
EPF	Employees Provident Fund
EPS	earning per share
et al.	*(et alia)*; and others
EVA	economic value added
GLCs	government-linked companies
i.e.	(*id est*); that is
KLSE	Kuala Lumpur Stock Exchange
KPIs	key performance indicators
MANOVA	multivariate analysis of variance
MB ratio	market to book ratio
MVA	market value added
n.d.	no date
NED	non-executive director
no.	number
OLS	ordinary least squares
p.	page
PCC	Pearson correlation coefficient
PNB	Permodalan Nasional Berhad
RI	return index
ROA	return on assets
ROE	return on equity
ROI	return on investment
ROS	return on sales
SGX	Singapore Stock Exchange
sig.	significance
SOE	state-owned enterprise
TSE	Tokyo Stock Exchange
UK	United Kingdom
US	United States
VIF	variable inflation factor

CHAPTER ONE

INTRODUCTION

1.1 INTRODUCTION

Corporate performance has been under scrutiny especially after the collapse of major companies such as Enron, Maxwell and Polly Peck, to name but a few. Different theories and ideas have surfaced, all trying to link the performance of a company to certain factors including the governance structures and procedures. Even though it is not easy to establish the link between firms' performance and their governance, there is still a widespread belief that governance best practices could lead to superior corporate performance (Young, 2003). Therefore, many researchers have attempted to provide some empirical evidence on this issue by using various methodologies such as developing the governance index and linking it to performance (e.g. Klapper and Love, 2004), focusing on event study (e.g. Baliga, Moyer and Rao, 1996 and Rosenstein and Wyatt, 1990) as well as searching for a relation between certain governance mechanisms and firm performance (e.g. Van Ees, Postma and Sterken, 2003; Kiel and Nicholson, 2003; Coles, McWilliams and Sen, 2001; Laing and Weir, 1999; Dalton, Daily, Ellstrand and Johnson, 1998; Barnhart and Rosenstein, 1998; and Agrawal and Knoeber, 1996).

The present study basically attempts to augment the existing evidence on the association between firms' performance and their governance mechanisms but taking into consideration the specific characteristics of Malaysian government-linked companies (GLCs) which will be used as the sample in the study. Four governance mechanisms that will be examined in the study are leadership structure, board composition, board size as well as managerial stock ownership.

1.2 BACKGROUND OF THE STUDY

The word ‘governance’ comes from the Greek word ‘*kubernaein*’ which means steer (Davies, 1999). Nonetheless, the concept of corporate governance has been viewed in different ways. Nelson (2004:2) defines corporate governance as ‘a set of constraints on managers and shareholders as they bargain to determine how the value of the firm will be allocated’. The author further contends that as the constraints become binding, the corporate governance practices will have the most evident impacts on firm performance. On the other hand, in a report published by the Malaysian Finance Committee on Corporate Governance in February 1999, corporate governance is viewed as ‘the process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realising long term shareholders value, whilst taking into account the interest of other stakeholders’ (p.10). From the latter definition, there is an implicit connotation that good governance practices should lead to better corporate performance.

Due to the lack of convincing evidence on the correlation between firm performance and corporate governance, many attempts have been done to shed some light on the issue. In a recent report by Credit Lyonnais Securities Asia (CLSA), it is showed that companies with high scores on the governance index have better operating performance as well as higher stock returns (Klapper and Love, 2004). In the study, CLSA calculated an index with corporate governance rankings for 495 firms across 25 emerging markets and 18 sectors (Klapper and Love, 2004). Using the data produced by CLSA as well as the data from Worldscope, Klapper and Love (2004) further examine the relation between corporate governance and performance of 374 firms across 14 countries namely Brazil, Chile, Hong Kong, India, Indonesia, Korea, Malaysia, Pakistan, Philippines, Singapore, South Africa, Taiwan, Thailand and Turkey. From the study, they conclude that better corporate governance is associated with higher operating performance (return on assets) and Tobin's Q. In addition, there is also evidence that the correlation between performance and corporate governance becomes twice as large and statistically more significant when the researchers include country fixed effects in their analysis.

Similar findings are also found in Bauer, Guenster and Otten's (2004) study. By using the corporate governance ratings of Deminor which cover most of the companies included in the FTSE Eurotop 300 in 2000 and 2001, they build portfolios comprising of well-governed companies and compare their stock returns, firm value and operating performance with the portfolios of poorly governed firms. Deminor's corporate governance ratings are based on 300 different criteria from four categories: (1) rights and duties of shareholders; (2) range of takeover defences; (3) disclosure on corporate governance and (4) board structure and functioning. From the analysis, it is evident that corporate governance positively affects common stock returns. Firm valuation is also found to be positively related to the quality of corporate governance standards in the European Monetary Union (EMU) firms, though the relationship is not so strong in United Kingdom (UK). Two reasons are given by the authors on why good corporate governance increases firm value. First, good governance increases investors' trust. Second, better-governed firms might also have more efficient operations which consequently yield higher expected future cash flow stream.

Even though some has attested the relationship between corporate governance and firm performance, there are still many others who are reluctant to accept that the performance of a company might be influenced by its governance structures. This is revealed in large-scale surveys of UK and United States (US) corporations where a majority of respondents believe that the increased focus on corporate governance has had no positive impact on financial performance (Kakabadse, Kakabadse and Kouzmin, 2001). The result is not surprising as according to Van den Berghe and De Ridder (1999), it is quite difficult to correctly establish the link between firm performance and corporate governance because there are many variables involved, each influencing the others.

In the case of Malaysia, corporate governance has become the crux of discussions especially after the 1997 Asian financial crisis. The failure of corporate governance has been blamed for the severity, if not the cause, of the crisis (Thompson and Mok, 2004, March). In 2001, a report by World Bank revealed that Malaysia was rated just one notch above Indonesia in terms of corporate governance standings for Asian countries ("Malaysia Near Bottom," 2001, April 30). Since then, many efforts have been done to burnish the country's image through a series of recommendations and regulations. Recently, a heightened focus has been given to the GLCs to improve their performance by strengthening their governance practices. This move has been taken due to the enormous contributions of the GLCs to the Malaysian economy. It is reported that even though GLCs comprise only five percent of the number of companies on Bursa Malaysia, they make up 34 percent of the total market capitalisation, which equals to RM 232 billion (US$ 61 billion), more than half of Malaysian Gross Domestic Products (Cheong, 2004). In 2005, their market capitalisation increases by two percent, reaches 36 percent of Malaysia's stock market ("An Attempt to Revive", 2005, August 18).

Thereupon, the present study will try to provide empirical evidence whether or not the step taken by the Malaysian government in improving the GLCs performance by focusing on their governance structures is worthy.

1.3 MOTIVATIONS OF THE STUDY

The divergent views, as well as mixed empirical findings regarding the relationship between firm performance and governance mechanisms motivate the present study. Thus, the study is designed to analyse the governance mechanisms in Malaysian government-linked companies (GLCs). Why GLCs? GLCs are chosen as the sample in the study due to the increasing attention given to them lately, as well as their unique characteristics such as having direct link to the government via shareholding plus the social and national obligations attached to them.

Furthermore, the restructuring of GLCs, which was announced by the Malaysia Prime Minister in May 2004, also focuses on the corporate governance practices in GLCs (Toh, 2004, May). This triggers a question whether the existing mechanisms in GLCs are ineffective or inappropriate. Although this is not tested directly, the study might provide some indication to this question by linking the governance mechanisms in GLCs to their performance. Besides, the social or national policy obligation is often used as the reason for GLC's underperformance (Toh, 2004, May). The study, on the other hand, may provide an alternative view that the underperformance may also be due to poor corporate governance.

The study is also motivated by the fact that most of the previous research has been done in the developed nations such as UK and US. It is hoped that the study will provide some insights on the governance issues in the developing countries such as Malaysia.

1.4 OBJECTIVES OF THE STUDY

The study in general attempts to analyse the characteristics and performance of Malaysian GLCs amidst the increasing public attention, scepticism as well as mounting criticisms. Specifically, the aims of the study are twofold. First, the study seeks to examine the governance mechanisms (i.e. leadership structure, board composition, board size, and managerial stock ownership) in Malaysian GLCs and their relationship to firm performance. Two financial measures of firm performance that are used in the study are return on assets (ROA) and Tobin's Q. ROA is one of the accounting measures of firm performance, while Tobin's Q represents market-based performance measure. Second, the study aims at analysing the substitution effect among the mechanisms on firm performance. This is due to the availability of various mechanisms and thus firms may make choices on how to design governance packages that suit their organisations (Coles et al., 2001).

1.5 SIGNIFICANCE OF THE STUDY

The study is slightly different from the previous studies as it tries to address the inadequacies in the previous studies, which focus only on one or two governance mechanisms and also ignore the substitution that may exist between the mechanisms. Furthermore, there is no prior empirical study in the context of Malaysia, to the best of my knowledge that examines the governance mechanisms in GLCs and their relationship with firm performance. As such, it is hoped that this study will extend our understanding regarding the characteristics of GLCs, as well as contribute to the growing literature on corporate governance and specifically on the association between governance practices and firm performance.

In addition, the findings from this study may be helpful in designing the best corporate governance structure in GLCs that will improve firm performance. This is due to the fact that there is no ‘one size fits all’ in corporate governance. Thus, unique characteristics of GLCs may require certain features in their governance package that might be diverse from other firms. The findings may also be useful in assessing the effectiveness of the governance mechanisms in GLCs by linking them to firm performance.

1.6 ORGANISATION OF THE THESIS

The thesis will be organised into six chapters, including this chapter, which signifies the introductory part of the thesis. The second chapter will provide further descriptions and discussions on Malaysian GLCs. It contains, among others, the definition of GLCs, background, criticisms and also discusses the state of corporate governance in Malaysian GLCs. This will at least provide clearer view on the upcoming issues regarding GLCs that will be discussed throughout the study.

The third chapter will then review prior research on the relationship between corporate governance and firm performance. The reviews will be structured into five sections, namely leadership structure, board composition, board size, managerial stock ownership and governance mechanisms as substitutes.

The research methodology used in the study will be discussed in the fourth chapter. In this chapter, detailed information on theoretical and hypothesis development; sample and data collection; variables and measurements will be highlighted. In addition, this chapter will also discuss in detail the data analysis techniques used as well as the model that will be tested in the study.

The fifth chapter basically presents the results and findings from the statistical tests performed on the relationship between governance mechanisms and performance in GLCs. Finally, the sixth chapter will conclude the study. It will also discuss the limitations of the study and offer some suggestions for future research.

CHAPTER TWO

GOVERNMENT-LINKED COMPANIES

2.1 INTRODUCTION

The purpose of this chapter is to highlight and discuss the issues related to government-linked companies (GLCs) such as the performance and corporate governance in GLCs. The chapter is organised into four parts. Firstly, the chapter explores various definitions of GLCs that can be found in prior literature. Secondly, the chapter discusses the background of Malaysian GLCs in terms of their historical background, characteristics, contributions and recent restructuring of the companies. Thirdly, the chapter unveils some of the criticisms on the GLCs, both in Malaysia and other parts of the world. Finally, the chapter analyses the current state of corporate governance in Malaysian GLCs as well as a few emerging issues.

2.2 DEFINITION OF GOVERNMENT-LINKED COMPANIES (GLCs)

In the simplest way, government-linked companies or GLCs are defined as those companies in which some shares are owned by the government (Fang, Qian and Tong, 2004). Though this definition seems understandable, it still creates unabated debates regarding the precise classification of GLCs. For instance, Singapore's Department of Statistics defines GLCs as companies in which the government's effective ownership of voting shares is 20 percent or more (cited in Ramirez and Ling, 2003). However, according to the US State Department in their March 2001 report, the aforementioned definition will exclude a number of second and third-tier GLC subsidiaries due to the effective ownership prerequisite (Ramirez and Ling, 2003). For example, if government owns 50 percent of company A (first-tier), and company A has a subsidiary (company B/second-tier) with 30 percent ownership, only company A will be considered as GLC because the effective ownership of the government in company B is only 15 percent. Thus, the US State Department decides that GLCs are 'entities in which a holding company wholly-owned by the government has a controlling share, as well as second, third and fourth tier subsidiaries of those entities in which the first, second or third tier entity, respectively, has an equity interest of at least 20 percent' (US Embassy, 2001, March:1). Back to the example given above, the latter definition by US State Department will confer both company A and B the GLC title.

Similar definition as given by the US Embassy has also been used by Fang et al., (2004) in their study but they restrict to only first and second-tier subsidiary. On the other hand, Ramirez and Ling (2003) classify a company as GLC if the government (via its investment company such as Khazanah Nasional in Malaysia and Temasek Holdings in Singapore) or a statutory board is one of the substantial shareholders in the company. According to the Companies Act, a person is considered as substantial shareholder if he/she has an interest in five percent or more of the voting shares of the company (Ramirez and Ling, 2003).

In the case of Malaysian GLCs, its narrowest definition refers to companies directly held by the government through the Minister of Finance Incorporated (MoF Inc.) or 100 percent owned entities such as Khazanah Nasional and Kumpulan Wang Amanah Pencen ("Complete Restructure of GLCs," 2004, July 26). In addition, GLCs can also be classified as those firms controlled by agencies such as Employees Provident Fund (EPF), Permodalan Nasional Berhad (PNB) as well as Tabung Haji due to the fact that these institutions are linked to the government ("Complete Restructure of GLCs," 2004, July 26).

For the purpose of the present study, as suggested by Ramirez and Ling (2003), companies are considered as GLCs if substantial shareholders in the companies are either the Minister of Finance Incorporated, Khazanah Nasional Berhad, Permodalan Nasional Berhad, Amanah Raya Berhad or statutory bodies (i.e. Employees Provident Fund, Kumpulan Wang Amanah Pencen, Lembaga Tabung Angkatan Tentera and Lembaga Urusan dan Tabung Haji).

2.3 BACKGROUND OF MALAYSIAN GLCs

GLCs are vital in Malaysian economy. Though GLCs account for only five percent of the total companies in Bursa Malaysia (formerly known as Kuala Lumpur Stock Exchange), their market capitalisation reaches RM 232 billion (US$ 61 billion), more than half of Malaysia's Gross Domestic Products (Cheong, 2004). Government holds the stake in GLCs mostly through Minister of Finance Incorporated, Khazanah Nasional Berhad, Permodalan Nasional Berhad and Employees Provident Fund (Cheong, 2004). GLCs spread across a wide spectrum of economic activities from infrastructure, telecommunications, agriculture as well as financial services (Liza, 2003). Due to the fact that Malaysian GLCs provide mission-critical services of the country, GLCs play a pivotal role in the operation of every commercial concern in Malaysia and contribute significantly towards improving the quality of life for the public (Abdullah, 2004, May).

In May 2004, the Malaysia Prime Minister, Datuk Seri Abdullah Ahmad Badawi announced restructuring of GLCs (Toh, 2004, May). This shake-up is expected to compel the GLCs to become more commercial in nature, despite their social and national obligations (Toh, 2004, May). Among the restructuring measures announced include the reduction in GLCs board size to between six and ten members, introduction of performance-linked compensation, board changes and appointment of new CEO (Cheong, 2004). GLC Transformation Manual has been released last July 2005, comprises of 10-year revamp programme (Tee and Nathan, 2005, December 31). This manual covers a broad spectrum of prescriptions from revamping boards to cutting procurement costs (Putrajaya Committee for GLC High Performance, 2005).

Malaysian government is very committed in enhancing the efficiency and performance of GLCs as it would bring about massive benefits, not only to the stock exchange but also to the income, consumption and wealth of the nation (Abdullah, 2004, May). This has also been reiterated by the CLSA Malaysia Head of Research, Shan Choo, where she noted that the good performance of GLCs will sustain the foreign interest in the local stock market and there has also been a surge in foreign interest in GLCs since the revamp of the companies initiated by the government (Leong, 2005, February 4). Even for an investor who has no ownership at all in GLCs, he/she will definitely hope for better performance from GLCs since they account for approximately 40 percent of the Malaysia'a Composite Index (Tee and Nathan, 2005, December, 31).

A substantial number of Malaysian GLCs in fact emerge from the privatisation policy initiated by the government in the nation. It was all started with the establishment of public enterprise or state owned enterprise (SOE) during Malaya's colonial era which was aimed at providing the public goods and services needed by British private enterprise to secure profits from their control of tin mining, plantation agriculture and international commerce (Jomo, 2002). In line with the privatisation wave that struck the world in the late 1970s initiated by the Thatcher government of the United Kingdom (Fang et al., 2004), these SOE faced the same exigency to change. This is particularly because of the contention that firms in private hands are