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THE EFFECT OF CORPORATE GOVERNANCE AND SHAREHOLDER MONITORING MECHANISMS ON COST OF CAPITAL: EMPIRICAL EVIDENCE FROM MALAYSIAN LISTED FIRMS FROM 2003 TO 2007

BY

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ABSTRACT

Although corporate governance issues emerged with the birth of corporations, they were largely unheard of in Malaysia until the Asian financial crisis in 1997-1998. The financial crisis basically serves as the impetus for corporate governance reforms in Malaysia. The government responded to an urgent call for corporate reforms and commissioned a committee to examine the issues of corporate governance. As a result, the Malaysian Code on Corporate Governance was introduced in 2000 to serve as a benchmark for firms to follow. Much has been debated about the state of corporate governance in Malaysian listed firms but evidence to date does not present adequate empirical case that corporate governance and shareholder monitoring mechanisms lower firms' cost of capital. Prior studies in Malaysia mainly measure value creation from the perspectives of accounting and market performances. There is an emerging brand of idea that firm value can also be viewed from the perspective of the ability of the firm to benefit from a reduced cost of capital as a result of a robust corporate governance. This study investigates the effect of corporate governance and shareholder monitoring mechanisms on firms' cost of capital between 2003 and 2007 from the theoretical perspectives of debt agency cost and the traditional manager-shareholder agency cost. Quality of firm corporate governance is measured using a comprehensive corporate governance index, which is developed for this study. Shareholder monitoring mechanisms are represented by ownership concentration, family, insider and government shareholdings. Using panel data regression technique, this study finds that overall corporate governance and shareholder monitoring mechanisms have a reducing effect on both costs of equity and debt. Both equity holders and debt issuers are willing to accept lower risk premium from firms that have robust corporate governance. In terms of shareholder monitoring mechanisms, family ownership reduces cost of equity whilst ownership concentration and insider ownership lower cost of debt.

ملخّص البحث

على الرغم من أن موضوعات حوكمة الشركات قد نشأت أو برزت مع مولد أو تاريخ الشركات، الا انها لم تكن معروفة في ماليزيا حتى الأزمة المالية الاسيوية في 1997-1998. و لقد خدمت الأزمة المالية، في الأساس، كدافع من أجل إصلاح أو تحسين حوكمة الشركات في ماليزيا. ولقد أستجابت الحكومة الماليزية للحاجة العاجلة أو الملحة للإصلاح، بتكليف لجنة من أجل دراسة قضايا أو موضوعات حوكمة الشركات. ونتيجة لذلك، تم إصدارالتشريع الماليزي لحوكمة الشركات في عام 2000 ليكون بمثابة مؤشر أو معيار للشركات لإتباعة والعمل به. ولقد كان هناك الكثير مما تم مناقشته حول حالة حوكمة الشركات في الشركات الماليزية المسجلة في سوق الأوراق المالية ولكن حتى الآن لم يوجد دليل عملي أو حالة تجريبية كافية، أثبتث أن آليات حوكمة الشركات ورقابة المساهمين تساهم في تخفيض تكلفة رأس المال. أن الدراسات السابقة في ماليزيا ركزت في الدرجة الأولى على قياس خلق القيمة من وجهة النظر المحاسبية والأداء في السوق. على الرغم من ذلك، هناك فكرة ناشئة فحواها أن قيمة الشركة يمكن أيضا أن ينظر إليها من منظور مقدرة الشركة على الإستفادة من إنخفاض تكلفة رأس المال كنتيجة لقوه آليات حوكمة الشركات. لقد تناولت هذه الدراسة تأثير آليات حوكمة الشركات ورقابة المساهمين على تكلفة رأس المال في الشركات بين عامي 2003 و 2007 من المنظور النظري لتكلفة الوكالة للديون و لتكلفة الوكالة للمساهم-المدير. ولقد تم قياس نوعية حوكمة الشركات بإستخدام دليل أو مؤشر شامل للحوكمة والذي تم تطويره لهذه الدراسة. وتمثلت آليات مراقبة المساهمين في تركيز الملكية، الملكية العائلية، والملكية الداخلية والحكومية للأسهم. وبإستخدام أسلوب تحليل معامل الإنحدار، أظهرت الدراسة أن آليات حوكمة الشركات ومراقبة المساهمين لها تأثير للحد من كلاً من تكلفة رأس المال وتكلفة الديون. كما أظهرت الدراسة أن كلاً من حملة الأسهم ومصدري الديون على استعداد لقبول قسط أقل للمخاطر من الشركات التي لديها آليات حوكمة قوية. ومن حيث آليات مراقبة المساهمين، أظهرت الدراسة أن الملكية العائلية تقلل من تكلفة الأسهم (رأس المال) في حين تركيز الملكية والملكية الداخلية تقلل من تكلفة الديون.

APPROVAL PAGE

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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.

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LIST OF ABBREVIATIONS

ACCA	The Association of Chartered Accountants
ATI	Anti-takeover Index
BMLR	Bursa Malaysia Listing Requirements
CalPERS	The California Public Employees Retirement System
CEP	Continuing Education Programme
CEO	Chief Executive Officer
CG	Corporate Governance
CGSC	Corporate Governance Score
CGM1	Board Structure and Procedures
CGM2	Board Compensation Practices
CGM3	Shareholder Rights and Relations
CGM4	Accountability and Audit
CGM5	Transparency
CGM6	Social and Environmental
CLSA	Credit Lyonnais Securities Asia
CSR	Corporate Social Responsibility
e.g.	For example
EON	Edaran Otomobil Nasional
EP	Earnings-Price
EPF	Employee Provident Fund
ESOSs	Employee Share Ownership Schemes
FAM	Family ownership
FGLS	Feasible Generalised Least Squares
FININT	Financial Intermediary Development
FTSE	The Financial Times Stock Exchange
GDP	Gross Domestic Product
GIM	Gompers, Ishii and Metric's corporate governance index
GMI	Governance Metrics International
GOV	Government Ownership
ICLG	Institute for Corporate Law and Governance
i.e.	That is
IRD	The Russian Institute of Directors
IRRC	Investor Research Responsibility Center
IndEP	Industry-Adjusted Earnings-Price ratio
INS	Insider Ownership
INTCOV	Interest Coverage Ratio
IntRate	Interest Rate
ISS	Institutional Shareholder Services
KCGI	Korea Corporate Governance Index
KLSE	Kuala Lumpur Stock Exchange
KPIs	Key Performance Indicators
KSE	Korea Stock Exchange
LEV	Leverage
LIBOR	London Interbank Offered Rate

LN(CGSC)	Natural Log of Corporate Governance Score
LN(INTCOV)	Natural Log of Interest Coverage Ratio
LN(LEV)	Natural Log of Leverage
LN(MTB)	Natural Log of Market-to-Book Ratio
LN(ROA)	Natural Log of Return on Assets
LN(TA)	Natural Log of Total Assets
LTAT	Lembaga Tabung Angkatan Tentera
MAP	Mandatory Accreditation Programme
MARA	Majlis Amanah Rakyat
MASB	Malaysian Accounting Standards Board
MCCG	Malaysian Code on Corporate Governance
MSWG	Minority Shareholders Watchdog Group
MTB	Market-to-Book Ratio
OECD	Organisation for Economic Cooperation and Development
OJ	Ohlson and Juettner-Nauroth Model
OLS	Ordinary Least Squares
OWN	Ownership
OWNCON	Concentrated Ownership
MESRA	Malaysian Environmental Reporting Awards
NEP	National Economic Policy
NUBS	Nottingham University Business School
PE	Price-Earnings
PEG	Price-Earnings Growth
PNB	Permodalan Nasional Berhad
PN4	Practice Note No. 4/2001
PN17	Practice Note No. 17/2005
PROTON	Perusahaan Otomobil Nasional
ROA	Return on Assets
ROE	Return on Equity
RIV	Residual Income Valuation
RM	Malaysian Ringgit
SandP	Standard & Poor’s
SEC	Securities and Exchange Commission
SEDC	State Economics Development Corporation
STKMKT	Stock Market Development
TA	Total Assets
TH	Muslim Pilgrim Saving and Management Authority
UiTM	Universiti Teknologi MARA
VIF	Variance Inflation Factor

CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

Ownership is separated from control in a widely held firm because shareholders do not manage the company themselves. Instead, they surrender a great deal of power to professional directors to make decisions and monitor the management of the company (Berle and Means, 1932; Pratt and Zeckhauser, 1985). Unfortunately, managers have the tendency to engage in opportunistic behaviours that is damaging to the objective of maximising shareholders' wealth (Williamson, 1985). This divergence of interest and the failure of the suppliers of finance to monitor the managers are the key contributors of corporate governance problems (Marris, 1964; Williamson, 1964; Grossman and Hart, 1980). Further, rampant conflicts of interest ultimately reduce the value of the firm, ceteris paribus.

Jensen and Meckling (1976) in their renowned theory of the firm paper applied agency theory to the modern corporation and formally modelled the agency costs of outside equity. They emphasised the fact that corporate contracts are incomplete; hence, unable to effectively control the self-interested behaviour of managers. As agency costs have damaging impacts agency theory suggests that firms establish quality corporate governance. Corporate governance is said to be able to mitigate agency costs arising out of the opportunistic managerial behaviour and the adverse impact of incomplete contracting. The notion of separation of ownership and control and the argument of agency theory appear to be highly relevant to the Western model of public corporation where ownership is widely dispersed.

As opposed to the prevalent dispersed ownership in Western countries ownership structure in developing countries and particularly Malaysia is highly concentrated in the hands of individuals or family groups (Claessens, Djankov and Lang, 2000; Roszaini and Mohammad, 2006). Owner-managed firm is a common business attribute in Malaysia. When ownership is highly concentrated the traditional agency conflict between shareholders and managers is still relevant, but less prevalent than the conflict between large shareholders and minority shareholders.

Large shareholders have greater control over the company and may expropriate firm wealth at the expense of minority shareholders as well other supplier of finance such as debt holders. The impact of expropriation tendency of large owners may be severe when they also serve in management capacity (Wiwattanakantang, 2001). In this context, effective corporate governance is meant to mitigate the adverse effects of agency conflicts between large owners and other suppliers of finance such as minority shareholders and debt holders.

Corporate governance has become prominent in the modern business scenario and has also been seen as the key to improving accountability and efficiency of public firms (see Jensen, 1989 and Rappaport, 1990). Public firms are a major concern given the intricate relationship between the outside shareholders and the management of the firms. In general, corporate governance encompasses a broad spectrum of internal and external mechanisms intended to mitigate agency risk by increasing the monitoring of managements' actions, limiting managers' opportunistic behaviour and improving the quality of firms' information flows in the context of separation of ownership and control.

In view of the widespread existence of firms characterised by this separation of control over capital from ownership of capital, corporate governance research

generally focuses on understanding the mechanisms designed to mitigate agency problems and support this form of economic organisation (Jensen, 1989). Ultimately, corporate governance will be able to induce self-interested controllers of a firm to make decisions and allocate resources that could maximise the value of the firm to its owners.

Corporate governance is defined in the Malaysian Code on Corporate Governance, 2000 [MCCG (2000)] 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 shareholder value, whilst taking into account the interest of other stakeholders." It is worth noting that in crafting the definition of corporate governance, the authority in Malaysia mainly emphasises the primary objective of a firm, which is to enhance shareholders' wealth.

The central tenet of the definition is addressing the presence of agency costs arising from the conflicts of interest between the managers (agents) and shareholders (principals). Although the definition includes the need for corporate management to take into consideration the interest of stakeholders, this point has not been adequately covered in the recommendations on best practices of corporate governance in the MCCG (2000).

According to Denis and Sarin (1999), corporate governance mechanism can be divided into internal and external oversight mechanisms. Internal oversight mechanisms refer to those practices and structures that can be established within the firm. Examples of internal mechanisms include board of directors, independent directors, board committees, internal control and audit, executive compensation system and equity holders. External oversight mechanisms refer to control

mechanisms available outside a firm such as market for corporate control or takeover market, legal and regulatory framework and stakeholders like creditors or debt holders.

Other than the board oversight mechanisms shareholder monitoring is an integral component of an effective corporate governance system (Denis and Sarin, 1999). In fact, according to Jensen (2000), ownership structure of a firm can be a potent corporate governance mechanism because it significantly influences a firm's corporate goals, shareholders' wealth and the extent of managerial opportunistic behaviour. In this study, the researcher takes the stand ownership structure represents the different types of shareholder monitoring mechanisms that could potentially complement or be an important component of a holistic corporate governance framework, particularly, in a study involving firms in an emerging market like Malaysia.

Ownership structure in Malaysian firms is unique because it is largely affected by national economic agenda. The Malaysian government has been actively involved in business enterprises by holding equity stakes in many listed firms. In addition, majority of Malaysian companies are built from family businesses as evidenced by the study of Claessens et al. (2000). They find that about 70 percent of Malaysian firms are family-controlled. They also document that corporate ownership is highly concentrated as opposed to highly dispersed in Western countries.

A survey by Thornton, Shamsir Jasani, Grant and the Malaysian Institute of Management in 2002 finds that Malaysian family firms evolved from small enterprises and grown to become giant conglomerates. The distinctive ownership structure of Malaysian firms enables investigation of an alternative corporate governance model that is applicable to an emerging market like Malaysia. In view of

the highly concentrated ownership in Malaysian firms the extent of the traditional agency conflict between shareholders and professional managers may be less severe than the conflict between major shareholder (owner-manager) and minority shareholders.

Given the notion that corporate governance is necessary to curb potential abuse of power and mismanagement of corporate managers, numerous studies have been conducted especially trying to establish its empirical benefits. If the theoretical debate on the benefits of corporate governance holds true, firms should be able to create more value for stakeholders. As such, prior studies mainly investigated the role of corporate governance in creating value for firms by linking various control mechanisms with measures of firm performance. Although the significance of corporate governance in public firms is widely acknowledged, its contribution to value creation for the suppliers of finance remains a subject of an open empirical question.

Corporate governance research is largely based on agency theory and in recent years it is supplemented by various corporate guidelines that come to light out of recent spate of corporate scandals involving corporate giants worldwide. In practice, many corporate laws require firms to have good corporate governance. Traditionally, corporate objectives tend to give priority to creating value for shareholders as the main supplier of capital.

Corporate directors are argued to owe a duty to shareholders only and hence, are obligated to maximise returns for them (Friedman, 1962; Sternberg, 1998; Lozano, 2000). This belief has shaped the ways in which corporate governance mechanisms, such as board of directors, play a role in aligning the interests of shareholders and company management. However, recent years have witnessed a growing interest in corporate responsibility in view of the disastrous impacts of firms' operations on the

environment and well being of other stakeholders such as employees and customers.

In view of this contemporary perspective, policies and corporate governance initiatives have highlighted the need to broaden the corporate governance agenda to not only focus on the interest of shareholders but also on the needs and requirements of all corporate stakeholders (Solomon and Solomon, 2004). This view is known as stakeholder perspective or theory. Stakeholder theory is relevant given the increasing pressure for businesses to voluntarily spend on advancing the welfare of the social stakeholders as well as protecting the environment (Robins, 2005). Businesses are also pressured to report such spending through annual reports. Other than the agency theory, this study adopts stakeholder perspective in evaluating firms' corporate governance quality of Malaysian public listed firms. This approach is seen as more inclusive or holistic given the current scenario.

Assessing Malaysian firms' corporate governance based on stakeholder theory is highly relevant given the fact that recent trend shows that in general, firms have made encouraging improvements in promoting stakeholder interests (see Zarina, 2002; Thompson and Zarina, 2004). The Association of Chartered Accountants (ACCA) Malaysia, Bursa Malaysia and Securities Commissions have introduced a few good initiatives to encourage firms to step up the activities that protect stakeholders' interest. The Malaysian government has also given tax incentive to firms that make corporate donations for philanthropic purposes. Further, in this study, debt holders are considered as important stakeholders where they may be exposed to expropriation risk due to rampant managerial opportunism and opportunistic major shareholders.

In Malaysia, corporate governance started to receive prominent interest in the aftermath of the financial crisis that hit once known as tiger economies of Asia in 1997-1998. Malaysia was one of the countries badly affected by the financial crisis.

Ever since there has been growing interest among researchers to understand the concept of corporate governance and the benefits it brings to shareholders in Malaysia. Similar to researchers in other jurisdictions Malaysian academic researchers tend to focus on the value creation power of corporate governance in the context of accounting performance and market values.

There is an emerging notion that firm value can also be viewed from the perspective of the ability of the firm to benefit from a reduced cost of capital as a result of robust corporate governance mechanisms (Donker and Zahir, 2008). As it stands today, to the best of the researcher's knowledge prior literature seem to give fewer attention to the effect of corporate governance on firms' cost of raising capital, which is directly related to shareholders' value. Given this scenario, this study intends to fill this knowledge gap and contributes to the understanding of this aspect of firm value in the context of corporate governance in Malaysia.

Theoretically, corporate governance and shareholder oversight mechanisms can minimise managerial and large shareholders opportunism and mitigate information asymmetry; thus, protecting the interest of equity holders and debt holders. Cost of equity can be reduced under two circumstances. First, equity holders may be willing to buy higher stakes in a firm, which may drive the equity prices up and reduces cost of equity. Second, shareholders who are confident on the ability of the firm to curb managerial opportunism and limit the information asymmetry may be willing to accept a lower risk premium, which lowers cost of equity.

In a highly concentrated ownership structure, debt holders consider agency cost as a risk in three ways. First, the management and large shareholders acting in their self-interest would resort to actions that are inconsistent with value maximisation, which could potentially affect firms' ability to honour their financial

commitments and increase default risk. Second, as stipulated in the contractual agreement debt holders do not usually have effective control on the use of funds they provide. Opportunistic managers and large shareholders may possibly divert these funds from the intended objective to the detriment of the debt holders. Agency risks are augmented when it is always problematic for the debt holders to enforce protective covenants as stipulated in lending agreements.

Third, debt holders rely on firms' financial reports to assess the true financial standing of the firms and the extent of default risk. Hence, they are very concerned about financial reporting validity, which could be doubtful due to information asymmetry (Daley and Vigeland, 1983; DeFond and Jiambalvo, 1994). In view of those risks associated with agency cost, debt holders are naturally very concerned about their ability to monitor and protect their investment (Smith and Warner, 1979; Kalay, 1982). Based on the risk-aversion properties, rational debt holders insist a premium (i.e. risk premium) for bearing agency risk, effectively raising the cost of debt.

In view of the risks associated with the agency cost of debt the extent to which debt holders are willing to accept lower risk premium (i.e. lower cost of debt) depends on the effectiveness of the firms' oversight mechanisms to curb managerial opportunism and the expropriation tendency of large shareholders. Hence, the theoretical link between firms' corporate governance quality and cost of capital is established.

Theoretically, corporate governance can lower cost of capital but evidence to date does not adequately present an empirical case to conclusively support this notion. Only few studies were conducted in this area and found some support that sound corporate governance lowers cost of equity (e.g. Battacharya and Daouk, 2002;

Ashbaugh, Collins, and LaFond, 2004; Cheng, Collins and Huang, 2006; Hail and Leuz; Derwal and Verwijmeren, 2007; Byun, Kwak and Hwang, 2008; Chen, Chen and Wei, 2009; Gupta, Krishnamurthi and Alireza, 2010) and cost of debt (e.g. Bhojraj and Sengupta, 2003; Anderson, Mansi and Reeb, 2004; Pittman and Fortin, 2004; Klock, Mansi and Maxwell, 2005; Blom and Schauten, 2006; Byun, 2007; Piot and Missonier-Piera, 2007).

Extant literature linking shareholder monitoring mechanisms and cost of capital is also scarce; thus, a systematic pattern of relationship cannot be established. There are only few studies linking concentrated ownership (e.g. Ashbaugh et al., 2004; Attig, Guedhami and Mishra, 2008), insider (e.g. Ashbaugh et al., 2004; Huang, Zhang and Wang, 2009) and family (e.g. Boubakri, Guedhami and Mishra, 2010) ownerships with cost of equity. To the best of the researcher's knowledge prior literature examining the direct effect of government ownership on cost of equity is non-existent.

Likewise, there are very limited extant literature linking concentrated ownership (e.g. Bhojraj and Sengupta, 2003; Cremers, Nair and Wei, 2007; Piot and Missonier-Piera, 2007; Pham, Suchard and Zein, 2008; Lin, Malatesta and Xuan, 2010), family (e.g. Anderson, Mansi and Reeb, 2003; Ellul, Guntay and Lel, 2006; Boubakri and Ghouma, 2010) insider (e.g. Anderson et al., 2004; Pham et al., 2008;) and government (e.g. Boubakri and Ghouma, 2010) ownerships to cost of debt.

Those prior studies report that to some extent the existence of good corporate governance and some types of shareholder monitoring mechanisms lead to firms being able to enjoy cheaper cost of capital. However, prior studies on this area are mainly conducted in the U.S. and Europe. Hence, it is envisaged that this quantitative study can help to establish a starting point for understanding the influence of corporate

governance on the cost of capital financing in Malaysian firms, an area that has received little attention to date. The next section discusses the research objectives and questions of this empirical research.

1.2 RESEARCH OBJECTIVES AND QUESTIONS

This research has three objectives. The first objective is to analyse the quality of corporate governance in Malaysian listed firms over the few years after the implementation of various corporate governance reform initiatives following the Asian financial crisis. The analysis will reveal the Malaysian listed firms' level of compliance with various corporate governance best practices over the period of 2003-2007. The second objective is to investigate the effects of corporate governance quality and shareholder monitoring mechanisms on the cost of equity and cost of debt of Malaysian public listed firms from 2003 to 2007. The third objective is to investigate the individual effect of corporate governance categories of the corporate governance index (the CG Index) on the cost of equity and cost of debt.

In this study, the CG Index is developed for the purpose of assessing firm corporate governance quality. The items of the CG Index are taken from the provisions of the MCCG (2000) and related prior studies. The CG Index consists of 139 items in six categories. The six categories are board structure and procedures, board compensation practices, shareholder rights and relations, accountability and audit, transparency and social and environmental activities.

McConaughy, Walker, Henderson and Mishra (1998) argue that prior studies mostly focused on concentrated ownership alone. They further posited that the use of concentrated ownership does not address the issue of shareholders' identities, which possibly explained the inconclusive findings in prior studies. Thus, this study