



THE IMPACTS OF CULTURE AND CORPORATE
GOVERNANCE ON THE PERFORMANCE OF
LARGE LISTED COMPANIES IN MALAYSIA

BY

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ABSTRACT

The purpose of this study is to examine the impact of culture and corporate governance on the performance of large listed companies in Malaysia. This study classifies culture into two perspectives i.e. ethnicity and management characteristics. Ethnicity is chosen because it may explain the impact of a particular racial or cultural group on firm performance. As for management characteristics, directors' characteristics such as age, education level, and tenure may explain their behaviours, attitudes, and choices, which in turn may affect firm performance. Board independence (independent non-executive directors), cross directorship, and board size are variables representing corporate governance. From the final sample of 89 companies, this study gathered information from annual reports for the year 2009. From the analysis, this study found that ethnicity does not have a significant impact on firm performance. As for management characteristics, older directors and directors with the appropriate level of education and skills would indirectly improve firm performance. For Malay-majority boards, board independence and large board size may contribute to a favourable firm performance. On the contrary, for Chinese-majority boards, all independent variables representing corporate governance related negatively with firm performance. Further, the relationship between board independence and firm performance (ROA and ROE) are negative and significant at 10% and 5% respectively. These results may be interpreted that too much emphasis on the role of independent directors may hinder board efficiency and effectiveness. The findings from this study may contribute to the accounting literature, research methodology and industry. Further, findings of this study may be useful for the investors in their decision-making.

خلاصة البحث

الغرض من هذه الدراسة هو دراسة تأثير الثقافة وحوكمة الشركات على أداء أكبر الشركات المدرجة في ماليزيا. هذه الدراسة تصنف الثقافة في منظورين العرق وخصائص الإدارة. تم اختيار العرق لسبب أنها قد تفسر تأثير العنصر العرقي أو ثقافة المجموعة على أداء الشركات. أما فيما يتعلق بخصائص الإدارة مثل العمر ومستوى التعليم ، والمنصب قد إختيرت لأنها قد تشرح تصرفات المديرين و مواقفهم و خيارتهم و التي بدورها قد تؤثر على أداء الشركة . إستقلالية المجلس (إستقلالية المديرين غير التنفيذيين)، تبادل المديرين ، وحجم المجلس هي المتغيرات التي تمثل حوكمة الشركات. وجمعت هذه الدراسة معلومات من التقارير السنوية لعام 2009 لعينة نهائية من 89 شركة . بعد التحليل وجدت هذه الدراسة أن العرق لم يكن له تأثير كبير على أداء الشركات. أما بالنسبة لخصائص الإدارة ، وأقدمية المديرين و مع مستوى مناسب من التعليم والمهارات من شأنها أن تحسن أداء الشركات بشكل غير مباشر. المجلس ذات الأغلبية المالاوية و استقلال المجلس، و كبر حجم المجلس قد تساهم في أداء أفضل للشركات .على العكس من ذلك ، المجلس ذات الأغلبية الصينية، وجميع المتغيرات المستقلة التي تمثل حوكمة الشركات ترتبط ارتباطا سلبيا مع أداء الشركة. علاوة على ذلك ، العلاقة بين استقلالية المجلس وأداء الشركات (العائد على الموجودات والعائد على حقوق المساهمين) و جدت سلبية ذات مغزى على مقياس 10 % . و 5% على التوالي .ويمكن تفسير هذه النتائج بأن المبالغة في التأكيد على دور المديرين المستقلين قد يعوق كفاءة وفعالية المجلس. وقد تساهم نتائج هذه الدراسة في مناهج البحث و الدراسات المحاسبية، والصناعة . كذلك إن نتائج هذه الدراسة قد تكون مفيدة للمستثمرين في صنع القرار.

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 research paper 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.

Intan Maiza Binti Abd. Rahman

Signature.....

Date.....

INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA

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Affirmed by Intan Maiza Binti Abd Rahman

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Date

Dedicated to
My beloved parents
Abd Rahman Bin Latif and Aishah Binti Mat
My husband, and My siblings

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LIST OF ABBREVIATIONS

ABDC	Accounting Based Debt Covenant
AGE	Average age of Directors on the boards
BoDs	Board of Directors
CEO	Chief Executive Officer
e.g.	<i>(exempligrantia)</i> : for example
EDSKILL	Average Education and Skills of Directors
EPS	Earnings per Share
et al.	<i>(et alia)</i> : and others
etc.	<i>etcetera</i>
ETHDOM	Ethnic Dominate (Ethnic Majority)
i.e.	<i>(id est)</i> : that is
IAS	International Accounting Standard
IJV	International Joint Venture
INED	Independent Non-executive Directors
MCCG	Malaysian Code of Corporate Governance
NDP	New Development Plan
NEP	New Economic Policy
NVP	National Vision Policy
OPP1	First Outline Perspective Plan
OPP2	Second Outline Perspective Plan
OPP3	Third Outline Perspective Plan
PROPCD	Proportion of Cross Directorship
R&D	Research and Development
RO	Research Objective
ROA	Return on Assets
ROE	Return on Equity
RQ	Research Question
TMT	Top Management Team
U.K	United Kingdom
U.S	United State
Y2K	Year 2000

CHAPTER 1

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

This study was carried out to examine the impact of culture and corporate governance on the performance of large listed companies in Malaysia. The term “culture” as used in the study refers to the national culture, and the definition used is that by Hofstede (1984), which is “the collective programming of the mind which distinguishes the members of one human group from another.” This study classifies culture into two perspectives, that is, ethnicity and management characteristics. Ethnicity refers to identity or membership in a particular racial or cultural group, while management characteristics refer to age, tenure, and education level of directors in the company. As for corporate governance, this study adopted the definition and requirements to the Malaysian Code of Corporate Governance 2000. The sample of the study comprised large listed companies in Malaysia. Malaysia being a multi-racial society comprising many ethnic groups is the ideal sample to study as this would provide the necessary and diverse information for a better understanding of the issues posed in the thesis.

A brief review of the history of Malaysia is relevant to provide the background for this research. Malaysia was formed in 1963 through a federation of the former British colonies of Malaya and Singapore. Malaysia has a combined population of over 25 million people. The Malays and other indigenous¹ population comprise the majority of ethnic groups (59%), followed by Chinese (32%) and Indians (9%).

¹ The Malays and other indigenous population are referred to as *Bumiputra* (Malaysia, 1991). Similar to what is used in Haniffa and Cooke (2002), *Bumiputra* refers to the Malays and vice versa. Throughout this study, the term *Bumiputra* and the Malays may be used interchangeably.

During the British colonial powers, plantation workers from India were imported to Malaya to work in the rubber plantations. The mines, mills and docks, on the other hand, had attracted workers from southern China to come to Malaya. Even though the Malays were the major residents in Malaysia, they worked in the rural areas and were still largely excluded from the modern economy. This situation led the Malays to be the majority of the poor, followed by the Indians and Chinese. The economic imbalances among the ethnic groups, especially between the Malays and Chinese eventually contributed to the race riots which happened in 1969.

After the racial riots in 1969, the Government introduced the New Economic Policy (NEP). NEP 1970 consists under the First Outline Perspective Plan (OPP1), covering the period 1971 to 1990. Under OPP1, the Government implemented four development plans, from the Second Malaysia Plan (1971-1975) to the Fifth Malaysia Plan (1986-1990). The NEP was formulated with the objectives of attaining national unity and fostering nation-building. The policy had a two-pronged strategy. The first strategy was to reduce and eliminate poverty, irrespective of race. During the time, the *Bumiputra* formed the majority of the poor. The second strategy was to restructure society by eliminating the identification of race with economic function. One of the thrusts under the second objective was ownership restructuring, where the target was to increase *Bumiputra* ownership of corporate share capital to at least 30% by 1990. This action directly or indirectly helped the Malays to get involved in business, thus helping them to get better allocations of wealth among other ethnic groups in the country.

The New Development Policy (NDP) was formulated under the Second Outline Perspective Plan (OPP2), covering the period of 1991 to 2000. The NDP was the policy that replaced the NEP 1970. The NDP provided a broader framework in

achieving the socioeconomics objectives i.e., to reduce poverty and to correct economic imbalances. As for the efforts of correcting economic imbalances, the NDP focused on the expansion of capacities to generate income and create wealth as well as to provide skills for the *Bumiputra* to effectively retain and manage their wealth. The focus to achieve 30% *Bumiputra* equity as targeted in the NEP 1970 continued to be implemented under the NDP.

The Third Outline Perspective Plan (OPP3) focused on building a resilient and competitive nation. The OPP3 was formulated based on a policy called National Vision Policy (NVP), and covered the period from 2001 to 2010. National unity and socioeconomic development remained the focus of the policy developed. While the NVP incorporated key strategies of the NEP (reducing poverty irrespective of race and restructuring society) and the NDP (emphasized on balanced development), it also introduced new policy thrusts. The example of the new policy thrusts were achieving effective *Bumiputra* participation as well as equity ownership of at least 30% by 2010, increasing the participation of *Bumiputra* in the leading sectors of the economy, and re-orientating human resource development to support a knowledge-based society.

The latest plan which refers to the Tenth Malaysia Plan (2011-2015) maintains the target of attaining at least 30% *Bumiputra* corporate equity ownership. However, the focus will be on promoting genuine economic participation, consistent with the objective of sustainable high growth, rather than corporate equity allocation. From all the plans discussed here, it shows that the efforts to improve participation in business among the Malays have remained thus over time. Therefore, it can be said that the affirmative policy set by the government influences business movements and decisions.

Besides the efforts taken by the government, the various cultures in the country may also affect behaviour, thus affecting business activities. As mentioned earlier, this study used ethnicity and management characteristics as variables to explain culture. In Malaysia, there are many ethnic groups, and Malays and Chinese are considered the major ethnic groups. The different ethnic groups in the country would have different cultures, which guide their behaviours or actions. Sendut (1991) and Lim (1998) argued that although the ethnic groups share similarities in cultural attributes, there are sufficient indications that suggest the existence of fundamental differences between them. The Malays are more oriented toward relationship building, prefer stability, and honour traditions, while the Chinese are more materialistic, adapt better to risks, and possess thrift qualities. With these differences, the Chinese are expected to be better in managing companies and may get better firm performance than the Malays, given that the Chinese are more oriented towards profit maximisation, and the attitude of being a risk taker may lead them to involve in high risk businesses which contributes high returns.

Other than ethnicity, management characteristics may also influence firm performance. Hambrick (2007) found that executives' experiences, values, and personalities influence their interpretations of the situation they face, and in turn, affect their choices. Further, Cheng et al., (2010) argued that management characteristics can be the dominant factors in shaping management's attitude, behaviour or goal. Differences in age, education level, and tenure as a company director may affect managerial skills, behaviour in solving problems, etc. As a proxy for culture, the inclusion of management characteristics would help the researcher to provide better explanation for the issues being studied.

The guidelines set in the Malaysian Code of Corporate Governance 2000 (the Code) might also influence or affect firm performance. As the aims of the Code which are to provide principles and best practices on structures and processes that can be used by companies in their operations, different corporate governance practices may affect firm performance differently. The Code was revised in 2007 to strengthen the board of directors and audit committee and to ensure both parties discharge their roles and responsibilities effectively. The newly revised Code shows that it is important for the company to conform or practice the guideline set in the Code in order to ensure the business can bring benefit to the company (in terms of good performance) and its stakeholders (in terms of good returns) as a whole. Further, the importance of practicing the guideline as mentioned in the Code was emphasized in the National Vision Policy 2001-2010. This indicates that implementing good corporate governance practices is perceived as a factor that could increase the chances for the company to earn better performance. The thesis continues by discussing the motivation of the study in the next section.

1.2 MOTIVATIONS OF THE STUDY

The government has developed the New Economic Policy (1970-1990), the New Development Policy (1991-2000), the National Vision Policy (2001-2010), and the New Economic Model. The objectives of the policies are to reduce poverty and to correct economic imbalances. One of the strategies that have been maintained since NEP 1970 until the Tenth Malaysia Plan (2011-2015) is to have 30% *Bumiputra* holding in public-listed companies. This requirement would affect business movements and decisions, such as employment pattern and ownership structure.

Further, listed companies in Malaysia have either Malay-majority directors or Chinese-majority directors on their board. Prior studies such as Haniffa and Cooke (2002, 2005) found that Malay directors had a positive influence to the level of voluntary disclosure. Carter et al., (2007) found that the existence of ethnic minorities on the board can improve financial performance. Further, Marimuthu (2008) found that increased ethnic diversity on the boards of directors would lead to higher firm performance.

As discussed in Sendut (1991) and Lim (1998), there are fundamental differences between the Malay and Chinese ethnic groups. The Malays are said to be more oriented toward relationship building, prefer stability, and honour traditions, while the Chinese are more materialistic, adapt better to risks, and possess thrift qualities. From these differences, it is assumed that the Chinese would perform better than the Malays. This is because the Chinese have the attitude of a risk taker and are focused on financial rewards.

As mentioned earlier, government affirmative policies may bring impact on ownership structure and employment pattern. The indirect impact from the requirement set in the government affirmative policies may lead the company to have either Malay-majority board or Chinese-majority board. Different ethnic group would have different cultural background and this may affect business movement and decision, which in turn affect performance of the company. There are very few prior studies which had examined the impact of culture (or ethnicity) on firm performance, especially in the multi-ethnic country like Malaysia. This issue has motivated this study.

Hambrick (2007) argues that the characteristics of top executives greatly influence their interpretations of the situations they face, which then affects their

choices. Further, Cheng et al. (2010) argue that demographic characteristics such as director's age, education level, and tenure shaped management's attitude, behaviour, or goal, which in turn affect organisational outcome. Other studies such as Auden et al., (2006) and Goll et al., (2008) provide evidence that top management characteristics influence firm performance. Auden et al., (2006) found that firms with a more homogeneous team regarding age and more heterogeneous team regarding functional background and tenure perform better. The results of prior studies mentioned here may suggest that older directors, directors with long tenure in the company, and directors who possess appropriate education level may increase the chances of the company to have a better performance. This is because directors with the characteristics mentioned earlier have greater experience and knowledge of their business, and this helps them to be more focused and clear on what they are doing (their decisions, etc.).

However, as the education system around the world is developing at increasingly higher levels, this would help the younger generation to obtain the appropriate levels of knowledge, which they can use and benefit the company they serve. In the case of Malaysia, the education system and opportunities can be considered as expanding, thus, increasing the chances for students to further their studies to higher levels. A younger workforce with good educational background would certainly improve the chances of companies to gain better returns, even though they have short tenures with the company. In the effort to get better return, it is assumed that appropriate levels of education may complement other characteristics such as age and tenure. Therefore, examining the effects of management characteristics using the Malaysian sample where the education system and education opportunities are expanding leads to the second motivation of the study.

The differences in corporate governance practices may also affect firm performance. For example, companies with the required number of independent directors on the boards are assumed to have better performance. As mentioned in the Malaysian Code of Corporate Governance 2000, the benefit of having one-third independent directors from the board size is to avoid one party to dominate board decision-making, and safeguard shareholders' investment and minority interest. In examining the impact of corporate governance practices using the Malaysian environment, Abdullah (2004), Hock (2005), and Mohd Ghazali (2010) found that board independence bring no significant impact on firm performance. As for board size, Abdul Rahman and Mohamed Ali (2006) found that a large board associates with monitoring problems, which decreases the earnings of the company.

To improve corporate governance practices, the Code was revised in 2007. The newly revised MCCG 2007 strengthen the role and responsibility of the board of director and audit committee in the effort to ensure both parties discharge their role and responsibility effectively. Implementation of corporate governance practices is one of the requirements for companies to get listed on Bursa Malaysia. Further, the importance of practicing corporate governance as suggested in the Malaysian Code of Corporate Governance was emphasized in the National Vision Policy (2001-2010). The emphasis was made with the belief that implementing good corporate governance would help companies to move towards corporate excellence.

As argued earlier, companies in Malaysia may have Malay-majority directors or Chinese-majority directors on their respective boards. Both ethnic groups have different cultural background where Malays are said to be more oriented toward relationship building, prefer stability, and honour traditions, as mentioned, and the Chinese more materialistic and adapt better to risks, among other things. For the

Malays, the implementation of corporate governance practices may be for the reason of conformation (to obey rules and superiors), and for the Chinese, it may be to help them reach their financial target. This difference would cause the cultural background to affect corporate governance practices, which then affects firm performance. This issue leads to the third motivation of the study.

1.3 OBJECTIVES OF THE STUDY

This study has two objectives. The first objective is to examine the relationship between culture and firm performance. This study classifies culture into two perspectives – ethnicity and management characteristics. As for ethnicity, Haniffa and Cooke (2005, pg.2) mentioned that “the inclusion of ethnicity (a proxy for culture) of decision makers within and without an organisation is important in some countries because the traditions of a nation are instilled in its people and might explain why things are as they are.” Given that there are many ethnic groups in Malaysia (with Malays and Chinese being the major ethnic groups), the use of ethnicity to proxy culture may provide an important insight on the relationship between culture and firm performance. Other perspectives, such as age, education and skills, and tenure are variables representing management characteristics. These variables relate to each director on the board. Prior studies such as Hambrick (2007) and Cheng et al., (2010) argued that demographic characteristics influenced executives’ choices, and affected firm performance. Using Malaysian companies as the sample, this study examines how individual characteristics (age, education level, and tenure) affect firm performance.

The second objective is to examine the effects of corporate governance practices on firm performance. For this objective, this study specifically examines the

impact of corporate governance practices on companies where majority of the directors on the boards are either Malays or Chinese. This study uses board independence, cross directorship, and board size as variables representing corporate governance structure. It is assumed that there could be differences in corporate governance practices between Malay-majority boards and Chinese-majority boards, given the differences in the cultural backgrounds between the two ethnic groups.

1.4 CONTRIBUTIONS OF THE STUDY

The findings of the study contribute to the accounting literature in a number of ways. Firstly, the majority of prior studies have examined the link between culture and accounting practices (accounting disclosure, accountant behaviour, accounting recognition and other accounting practices). Only a few studies, for example, Carter et al., (2007) and Marimuthu (2008) have examined the relationship between culture and firm performance. As there exists a cultural difference between Malays and Chinese (in terms of risk taking, financial focus, etc.), examining firm performance based on these differences can contribute to the accounting literature and complement theoretical arguments made by prior studies such as Sendut (1991) and Lim (1998).

Secondly, this study used management characteristics as a proxy for culture. The use of management characteristics could help to better explain directors' behaviour, attitude, and decisions made by them. Prior studies such as Cheng et al., (2010) found that demographic characteristics such as directors' age and education level have a positive impact on firm performance. As education system and opportunities in Malaysia are expanding, examining the impact of education level of directors (one of the variables of management characteristics) on firm performance could benefit and complement efforts made by the government through the Ministry

of Higher Education, in enhancing and strengthening the education system. Further, the findings from this study may also be useful for companies in their staff (or director) recruitment.

Thirdly, by examining the differences in performance of companies between Malay-majority boards and Chinese-majority boards, this study would be able to provide empirical evidence on the effectiveness of government's affirmative policies i.e., NEP 1970, NDP, and NVP. In all policies, the government aims to correct economic imbalances, and the major ways are by having the requirement of 30% of *Bumiputra* share capital, employment restructuring, and the creation of Bumiputra Commercial and Industrial Community (BCIC). The findings from this study would provide empirical evidence on how these requirements affect companies' decision making and firm performance. Further, the findings could provide valuable suggestions to policy makers (such as, the Economic Planning Unit) on how to further strengthen or enhance the relevant policies.

Lastly, this study examined the effects of corporate governance practices on firm performance, specifically for companies grouped under the Malay-majority boards and Chinese-majority boards. As discussed earlier, prior studies such as Abdullah (2004), Hock (2005), and Mohd Ghazali (2010) found mixed evidence on the impacts of corporate governance practices on performance of Malaysian-listed companies. This study however differs from Abdullah (2004), Hock (2005), and Mohd Ghazali (2010) as this study examined the impact of corporate governance practices on firm performance by focusing specifically on boards that show majority membership of two ethnic groups (Malay-majority Boards and Chinese-majority Boards). This difference could be considered as the contribution of this study.