РАЗДЕЛ 1
НАУЧНЫЕ ИССЛЕДОВАНИЯ
И КОНЦЕПЦИИ

SECTION 1
ACADEMIC
INVESTIGATIONS
& CONCEPTS

THE ENIGMA OF CORPORATE GOVERNANCE

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Abstract

The issue of corporate governance has in recent years received more attention than it would ordinarily have in the light of series of corporate failure that gave rise to implications the affect not only those directly connected with the corporations concerned, but also those affected by its existence such as employees, customers, suppliers and the environment. This interest is further aggravated by occurrences of major corporate failures such as the collapse of the BCCI Bank, collapse of the Barings Empire, the Daiwa Bank debacle and the Maxwell affair which all have pointed to the lack of a proper corporate governance system as a major course. Studies have shown that a majority of corporate failures were predominantly dominated by one individual, occupying a position of trust, who apart from losing large amounts of money also committed illegal acts.

Keywords: ownership, governance, corporate control

Introduction

The age-old concept of corporate governance has been brought back to life, especially after the series of corporate failure like Enron or WorldCom. This is because the implication of corporate failure is not only directly connected with the corporation concerned, that is the directors, shareholders and audi-

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tors of the corporations, but also affecting the employees, customers, suppliers and the environment. In fact, corporate governance is all about transparency and accountability, which seems simple enough to comprehend, but it gets more complex when it delves into the corporate related issues (Low *et al.*, 2001).

Corporate governance involves owner/shareholders, managers and directors, and getting these people to work together for the same goal is what the corporate governance movement is all about. The ultimate goal is to realize long-term shareholder value, whilst taking into account the interests of other stakeholders.

In this paper, we will examine various aspects of corporate governance in Malaysia. The discussion include the legal and regulatory framework, ownership structure, shareholder control and protection, the market for corporate control, the role of Malaysian banks in the corporate governance, the attributes of failed listed companies and also provide some information on the corporate governance standard in Malaysia.

The Legal and Regulatory Framework

The laws, regulations and standards that governing the operation of companies in Malaysia are company laws, securities laws and regulations, exchange listing requirements, financial accounting standards, insolvency laws and regulations, contract, labor, employment, commercial laws and consumer protection laws. Corporate law is primarily set out in the Companies Act 1965 (No. 125) which is based on the British Companies Act 1948 and the Australian Uniform Companies Act 1961. Major subsidiary legislation in the corporate law includes the Companies Regulation 1966, Companies (Winding Up) Rules 1972. As for the public listed companies (PLCs), they are governed by Securities Industries Act 1983, the Securities Commission Act 1993, the Malaysian Code on Take-over and Mergers 1998, the Guidelines on the Regulation of Acquisition of Assets, Mergers and Take-overs and the Kuala Lumpur Stock Exchange (KLSE) Listing requirements and Practice Notes.

The Malaysian Companies Act 1965, which is administered by the Registrar of Companies, sets out requirements for the birth, death and existence of companies. It identifies fundamental rules governing procedures for incorporation, the basic constitutional structure and the cessation of existing companies. Securities laws, which are overseen primarily by Securities Commission (SC) and the Kuala Lumpur Stock Exchange (KLSE), have increasingly made inroads into areas traditionally within the domain of company law, though these are generally in the context of PLCs. The thrust of securities laws by contrast is directed at laying the infrastructure necessary to promote sound and transparent capital markets and therefore better investor protection. The listing requirements of the KLSE also regulate the affairs of PLCs. In fact, the rules are not merely confined to keeping fair and informed markets through the various disclosure requirements, they also directly affect the conduct of a company's affairs. For example, the size of independent director participation on boards, the requirement for audit committees, or the introduction of rules restricting directorships of directors of PLCs. The legal and regulatory framework is set to govern a good corporate governance system in Malaysia.

Ownership Structure

Ownership structure is the most important factor in shaping the corporate governance system of any country. In particular, it determines the nature of the agency problem, that is, whether the dominant conflict is between managers and shareholders, or between controlling and minority shareholders. We will study the two key aspects of corporate ownership structure in Malaysia: concentration and composition.

Ownership Concentration

The degree of ownership concentration in a company determines the distribution of power between its managers and shareholders. When ownership is dispersed, shareholder control tends to be weak because of poor shareholder monitoring. On the other hand, when ownership is concentrated, large shareholders could play an important role in monitoring management.

On the issue of corporate ownership structure in Malaysia, the top five shareholders owned 58.8% and the top 20 owned 80% of total outstanding shares of an average PLC (Lai *et al.*, 1999). A fundamental problem in corporate governance under concentrated ownership is how to protect minority shareholders from the expropriation by controlling shareholders.

Controlling shareholders may act in their own interests at the expense of minority shareholders and other investors. This could take the form of paying themselves special dividends, committing the company into disadvantageous business relationships with other companies they control, and taking on excessively risky projects inasmuch as they share in the upside while the other investors, who might be creditors, bear the cost of failures.

In February 1998, Securities Commission announced a revision of the regulations governing the distribution of shareholdings of companies seeking listing on the KLSE. Companies seeking main board listing are required to ensure that at least 25% of shares are held by a minimum number of dispersed public shareholders holding not less than 1,000 shares each. The minimum number is 750 or 1,000 depending on whether a company has a paid-up capital of less or more than RM100 million.

Ownership Composition

The ownership composition refers to who are the shareholders or more importantly, who among them belong to the controlling group(s). The nominee company was the largest shareholder group among the top five shareholders in Malaysia. In 2002, the nominee companies held 46.5% of the total shares of an average non-financial PLC while the rest were shared by non-financial companies (22.5%), the government (20.5%), finance companies (5.9%), individuals (3.4%) and foreign investors (1.2%) (BNM, 2002).

This ownership pattern has changed little overtime and it is believed that the majority of shareholdings by the nominee companies and institutions (non-financial and finance companies) are owned by families. The institutional holdings are in part due to the government's effort to reallocate corporate shares to indigenous Malaysians and the countervailing efforts of non-indigenous Malaysians to maintain their ownership. Shareholders opt for nominees as a means of not revealing the identities of true holders – a practice that is to some extent the result of the government's effort to shift the balance of ownership towards the indigenous Malay population.

Shareholder Control and Protection

When ownership is separated from management, a basic question for shareholders is how they can effectively monitor managers and exercise control so that the managers will act in the shareholders' best interest. A number of mechanisms exist for shareholder monitoring and control. The most important are the system of the board of directors, shareholder participation through voting during shareholder meetings, performance-related executive compensation, legal protection of shareholder rights, and transparency and disclosure requirements (Setapa, 2001). These mechanisms are mostly embedded in corporate laws and other legislation. Furthermore, the Companies Act 1965 stipulates that every company in Malaysia must have one or more company secretaries who must be resident in Malaysia. The key role of the company secretary is to ensure that all relevant laws, regulations and requirements are strictly followed by the company and there is compliance with the correct procedure. In early 1999, Malaysia introduced a self-regulatory Malaysian Code of Corporate Governance which laying down 70 recommendations for PLCs to follow.

Board of Directors and Fiduciary Responsibilities

Board of directors monitor managers and control companies on behalf of all shareholders. Boards are expected to formulate corporate policy, approve strategic plans, authorize major transactions, declare dividends, and authorize the sale of additional securities. They are also expected to hire, advise, compensate and, if necessary, remove management, arrange for succession, and determine the size of boards and nominate new members, subject to approval by shareholders.

The effectiveness of board of directors in monitoring managers and exercising control on behalf of shareholders depends on a number of factors. A widely held view is that (i) the representation of independent or non-executive directors on boards, (ii) independent board committees for remuneration, nomination and auditing, and (iii) splitting the role of the chief executive officer (CEO) from that of chairman of the board.

i) *Independent and Non-Executive Director*

In Malaysia, a study of 92 PLCs at the main board of KLSE shows that 48% of them have executive chairmen on their boards while only 23% have non-executive chairmen (KLSE, 1999). An analysis of large PLCs reveals that only a few have non-executive directors as chairmen of boards, while some chairmen are appointed by the government. In the KLSE/PricewaterhouseCoopers corporate governance survey (2002), indicates a reasonably proportionate mix of independent non-executive directors, non-executive directors and executive directors. Almost all (90%) of companies have at least in name, 2 independent directors of which half (49%) have 2 independent directors and nearly a quarter (23%) have 3 independent non-executive directors. This is in line with the Listing Requirement (LR) of the KLSE which was launched on the 22 January 2001 stipulated that PLCs will be required to ensure a minimum number of independent directors, that is at least 2 directors or 1/3 of the board of directors of a listed issuer, whichever is the higher must be independent.

In March 1999, the KLSE imposed restrictions on the number of directorships in order to enhance the level of corporate governance exercised by directors of the listed companies in undertaking their duties. Directors are not allowed to hold more than 25 directorships in PLCs and more than 15 directorship in non-PLCs.

ii) *Audit and Remuneration Committees*

Under the LR, all PLCs must have audit committees comprising 3 members of whom a majority shall be independent. The profile of audit committee members surveyed by the KLSE/PricewaterhouseCoopers is detailed in Table 1 below.

Table 1. Profile of Audit Committee Members in Malaysia

Representation	Majority	About Half	Minority	None	No Answer
Financial professionals	20%	17%	37%	21%	5%
Legal professionals	6%	8%	23%	52%	11%
Retired Industry Leaders	7%	6%	17%	61%	9%
Retired Senior Government Officials	9%	6%	32%	45%	8%

Some PLCs have the internal audit function even though law does not mandate this requirement. In this survey, about 68% PLCs that responded to the survey have internal audit functions and 33% out of those have outsourced this audit function.

The Code of Corporate Governance has set out an additional function for the audit committee, which is to consider and investigate any matter that raises questions about management integrity, possible conflicts of interest or abuses by a significant or controlling shareholder.

The Code further recommends that if the board fails to take any action on the findings of the audit committee, the directors of the audit committee should be required under the listing rules of the KLSE to report the matter directly to the KLSE. KLSE has established the Taskforce on Internal Controls with the objectives to formulate and issue the guidance in assisting PLCs to report the state of their internal control in their annual reports.

The remuneration committee whose members comprise mainly non-executive directors is a relatively new concept in Malaysia. One out of five PLCs already have remuneration committees in Malaysia.

However, no data is provided on the membership of these committees. The Malaysian Code on Corporate Governance stresses that the membership of the remuneration committee should be disclosed in the director's report and the details of remuneration of each director should be disclosed in the company annual report.

iii) Executive Compensation

The compensation of executives plays a central role in corporate governance in aligning the interests of managers and shareholders. The exact form of the optimal incentive package depends on the specific details of the agency problem but often involves performance-related pay and the award of stock options to managers.

In Malaysia, the country study found that board chairmen and the CEOs are mostly paid by fixed salary (Aziz, 2002). Only a few companies have reported that their CEOs get a fixed salary plus performance-related pay including stock options. Generally, the CEOs propose the remuneration packages for approval by the boards, or alternatively, they are proposed and approved by the boards or by the remuneration committees.

Shareholder Participation and Protection

A sound corporate governance system requires that shareholders can actively participate in, and exert influence on, corporate strategic decision-making. This depends on whether shareholders' legal rights are adequately protected. In Malaysia, the Companies Act 1965 stipulates a number of shareholders' right. They have access to regular and reliable information; can call emergency shareholder meetings and make proposals at shareholder meetings. Companies have to disclose specified information to shareholders, such as connected interests, company affiliation, affiliated lenders or guarantees, among others. Shareholders are entitled to full pre-emptive rights on new stock issues unless they have voted to do otherwise. The law protects shareholders by:

- Stipulating regulations governing the duties of company directors
- Requiring annual general meeting (AGM) approval for the acquisition or disposal by directors of assets of substantial value, and for the issue of shares
- Prohibiting loans to directors or director-related parties, unless they are subsidiaries
- Disclosing and requiring shareholders' approval on substantial transactions in any non-cash assets involving directors or persons connected with directors
- Disclosing substantial shareholdings to the company and the KLSE

The Securities Industry Act (SIA) 1973 set a milestone for the protection of investor interests. Among others, it aimed at curbing excessive speculation, insider trading, share rigging and other forms of market manipulation. A new SIA came into force in 1983, which provides more effective supervision and control of the securities industry by regulating the operations of dealers, and prohibiting artificial trading and market rigging.

Thus, the rights and protection of shareholders in Malaysia appear to be both comprehensive and well defined. However, it is found that the number of shareholders who voted at annual general meetings is low and rejections of proposals, put forward by management or the board of directors at the AGMs, are few (Chong 2001). In the case of locally controlled companies, the control, exercised by the major shareholders is usually in excess of their cash-flow rights. Foreign-owned firms are seen to pay more attention to shareholder rights and pay out a higher level of dividends.

Transparency and Disclosure

Transparency and information disclosures are keys to effective shareholder control and protection. Information about a company usually includes financial results of the company, major share ownership, the members of the board of directors and key executives and their remuneration, foreseeable major risk factors, governance structures, and company objectives and policies. Good corporate governance based on transparency and the exit route is critically dependent on a country's accounting, auditing, financial reporting and disclosure standards and practices. Malaysia has been adopting, starting from the late 1970s the accounting standards that are generally consistent with those issued by the International Accounting Standards Committee (IASC). The approved accounting standards, Malaysian Accounting Standards (MAS) cover issues not dealt with by the IASC and reflect particular features of the Malaysian business environment. The Research Institute of Investment Analysis in Malaysia (RIIAM) was established in 1985 by the KLSE to enhance the level of investment analysis, research and professionalism in the Malaysian securities industry.

The Market for Corporate Control

The market for corporate control is composed of individuals and firms that buy ownership positions in or take over potentially undervalued corporations. Normally, the undervalued firm's executives will be replaced because they are responsible for formulating and implementing the strategy that led to poor performance.

During the 1997 Asian financial crisis, numerous mergers, acquisitions and restructuring happened in Malaysia. Before the crisis, Malaysia has several regulations in governing the merger takeover activities. For example, the Malaysian Code on Takeovers and Mergers which came into effect in April 1987 is aimed at ensuring that all takeovers and mergers are conducted in an orderly manner and at protecting minority shareholders. In 1993, penalties for breaches of the Code became stricter. Greater disclosure of information is required so that the shareholders could assess whether or not to accept a take-over. The new law also intends to ensure that minority shareholders are treated fairly. The new Malaysian Code on Takeovers and Mergers that came into effect in 1998 increases the market disclosure requirements relating to takeovers. The new Code requires that shareholders be given all necessary information. Criminal liability is imposed on relevant parties providing false or misleading information. Standards of disclosure in cases of takeovers are generally enhanced and amendments are made for this purpose in the KLSE listing rules, effective from 1999. Provisions relating to "creeping" takeovers have been amended to reduce the amount of time required for an acquirer to accumulate shares in a target firm.

Banks as Large Creditors

The banks in Malaysia play a dominant role in lending, but not in the governance except insolvency. They appoint receivers or liquidators. For companies which are not insolvent but illiquid and which require to be restructured or rehabilitated, the procedures for turning control over to the banks (including the rules for them to change managers and directors) are not well established. Nonetheless, the legal environment is more favorable to the creditors. In the absence of well-established rules for the rehabilitation of companies, this may have caused firms which suffering from illiquidity to be driven into insolvency.

Why Malaysian Companies Fail?

Mohamad et.al. (2001) have analyzed the general characteristics on the 68 failed PLCs listed on the KLSE during the period 1980 to 1998. These PLCs are seeking protection under the Section 176 of the Company's Act 1965 or approved by the regulatory body to undertake restructuring process. The details of analysis are as follow.

Table 2. General Attributes of Failed Listed Firms

	Failure Year	1	2	3	4	5
Qualified Audit Report	75%	38%	28%	22%	16%	5%
Director's Report	85%	31%	16%	5%	5%	5%
Type of Auditor (Big Six)	53%	53%	49%	46%	43%	41%
Auditor Changes	7%	1%	3%	3%	3%	0%
Size of BOD	6.2	6.0	6.6	6.8	6.5	6.5

Note: 1, 2, 3 4 and 5 denote one, two, three, four and five years before failure year

The qualified audit report means that the auditor is not fully satisfied on the fairness and reliability of the information reported, and the firm is usually associated with some form of problem. The above analysis showed that 75% of the qualified audit report during the failure year, however, only 53% were issued by big-six audit firms. In comparison with the auditor's qualified reports, 85% of the director's report of the failed firms mentioned about the financial ill-health in the year of failure. This is not surprising because the directors are more informative about their firms.

The analysis also includes the financial indicators comprising the liquidity, profitability, cash flows and leverage ratios and is detailed as follow:

Table 3. Average Values of Financial Ratios of Failed Firms from 5 Years before Failure

	Failure Year	1	2	3	4	5
Current Ratio	0.5932	0.8694	1.0518	1.0720	1.2596	1.3295
Quick Ratio	0.4185	0.5337	0.6186	0.6537	0.8603	0.8937
Return on Equity	-2.6989	-0.3720	-0.1058	-0.0628	-0.0047	0.1661
Return on Assets	-1.2258	-0.4023	-0.1842	-0.1091	-0.0476	-0.0057
Operating Cash Flow to Current Liabilities	-0.1163	-0.1230	-0.0211	NA	NA	NA
Operating Cash Flow to Total Liabilities	-0.2213	-0.0982	-0.0199	NA	NA	NA
Long Term Debt to Total Equity	0.6420	1.1994	1.4554	0.7303	0.5223	0.4022

All ratios (except the leverage ratios) showed a gradual deterioration. This deterioration was even more significant one year before the failure year and in the failure year. In other words, financial ratios may serve as the better indicator in the prediction of the failed PLCs listed on KLSE.

Corporate Governance Standard in Malaysia

The lack of good corporate governance was cited as one of the contributory factors in the Asian financial crisis during 1997-98. Since then, the Malaysian government has introduced the new guidelines and listing requirements for governing the operation of companies in Malaysia. In the follow-up of the 1998 benchmark survey on the level of corporate governance in Malaysia, the KLSE and Pricewaterhouse-Coopers (PwC) were jointly conducting the Corporate Governance Survey 2002 to gauge the current perceptions and expectations of the level of corporate governance in Malaysia. The results of the survey revealed that the corporate governance gap between Malaysia and other Asia Pacific economies has narrowed since 1998.

For instances, the level of board independence has adopted a clear division of responsibilities between the head of the board and the head of the company management. On the other hand, institutional investors claimed that they are prepared to pay at least a 10% premium for organizations that have good corporate governance practices. Companies also recognized that the importance of good communications with shareholders and investors as a tool to enhance investors' confidence.

In 2003, Public Bank and IJM Corporation have been named as the joint winners for the Malaysia Business Corporate Governance Award. In addition, three other companies were also commended at the awards; they are Malayan Banking, Nestle Malaysia and Esso Malaysia. The winners were selected based on the company's financial transparency, ability to enhance shareholder value, risk management and investor relation practices, internal checks and balances and regulatory compliance.

Conclusion

The corporate governance system in Malaysia is a result of the interplay of political, economic, legal, cultural and historical factors. To entrench a sound corporate governance principles and good practices in Malaysia, the stringent legislation and regulation alone is not sufficient. It has to be the combination of a strong culture of ethics, honesty and good sense, which based on the principles of trust, transparency, accountability and fairness. Good corporate governance is essential in setting up a sound framework for a vibrant market economy because it will enhance the investors' confidence and attract the flow of capital into our industries. More importantly, there are global forces pushing for better corporate governance standards all over the world. If Malaysia wishes to be part of the global capital market, we have to further enhance the corporate governance in Malaysia and bring its standard to the greatest height.

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