

# DOES BETTER CORPORATE GOVERNANCE ATTRACT FOREIGN EQUITY OWNERSHIP? EVIDENCE FROM MALAYSIAN LISTED COMPANIES

Yap Voon Choong\*, Chan KokThim\*\*\*, John Stanley Murugesu\*\*

## Abstract

This study examines the effect of firm-level corporate governance variables on foreign equity ownership (FEO) in Malaysia. Foreign equity ownership can be an important source of capital for companies to fund their expansion and growth. To attract FEO, good corporate governance practices are vital because these practices are used to reduce or mitigate agency cost. Based on a sample of listed firms on Bursa Malaysia and employing multiple regression analysis, the study finds that a number of corporate governance mechanisms significantly improve the ability of companies to attract foreign equity ownership, especially, Insider Ownership, Government Ownership, Firm Size, Dividend Yield and Tobin's Q. The results of the study indicate that firm-level efforts for better corporate governance sends positive signals and confidence to foreign investors.

**Keywords:** Foreign Equity Investment, Corporate Governance, Stock Ownership

\*Corresponding author. Faculty of Management, Multimedia University, Jalan Multimedia, 63100, Cyberjaya, Selangor, Malaysia

Tel.: 03-8312-5659

Email: [vcyap@mmu.edu.my](mailto:vcyap@mmu.edu.my)

\*\*Taylor's Business School, Taylor University, Selangor, Malaysia, Block E, Level 9, Lakeside Campus, No. 1, Jalan Taylor's, 47500 Subang Jaya, Selangor, Malaysia

Tel: 03-5629-5000 ext 5618

Email: [JohnStanley.StephenMurugesu@taylors.edu.my](mailto:JohnStanley.StephenMurugesu@taylors.edu.my)

\*\*\*Faculty of Management, Multimedia University, Jalan Multimedia, 63100, Cyberjaya, Selangor, Malaysia

Tel.: 03-8312-5661

Email: [ktchan@mmu.edu.my](mailto:ktchan@mmu.edu.my)

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## 1. Introduction

Foreign equity ownership (FEO) is becoming an increasingly important source of capital for Malaysian public listed companies. FEO can take the form of foreign portfolio investment (FPI) or foreign direct investment (FDI). Although both forms of investment result in equity ownership by foreigners, they have pro and cons. Specifically FDI is the entry of funds into a country where foreigners purchase a minority stake in a company. In contrast, FDI involves the investment in the assets of a company achieved through acquisition of a controlling interest (Neumann et al 2009). Hence, FPI tends to be more speculate in nature while FDI more long term and less volatile. A case in point being the Asian economic crisis in 1997 that saw the capital flight of FPI from South East Asian countries and the rapid decline of their currencies. Because FDI is more permanent, countries

normally prefer foreign equity participation to come from FDI.

One of barriers faced by local companies in raising new equity finance is the lackluster performance of the Malaysian stock exchange and subdued local investor sentiment in the aftermath of Global Financial Crisis in 2009. This has forced many Malaysian companies to look overseas to finance their expansion. However, the fallout from the Financial Crisis resulted in a drastic drop in Malaysia's share of inward direct foreign investments from US\$7.32 billion in 2008 to US\$1.38 billion in 2009 (UNCTAD, 2010). While foreign capital inflows can fluctuate from year to year, the magnitude of the decline should be a cause for concern for Malaysia as its immediate neighbours such as Singapore, Thailand and Indonesia managed to attract considerably more foreign investment. In the past, most inward capital

flows have been to the US, European Union and Japan because of their well developed financial markets and strong regulatory frameworks (UNCTAD, 2010). Despite the fact that foreign equity investment in emerging economies is increasing, competition among countries is intensely high. As domestic sources of outside finance dry up, many countries have been liberalized their foreign equity ownership restrictions and foreign capital has become an increasingly important source of finance for expansion (Bekaert, Harvey, and Lumsdaine, 2002). In this regard, corporate governance is becoming a very important strategic tool because one way companies can compete for foreign capital is on the basis of how well they represent the interests of foreign investors.

In order to attract outside investors, firms need to implement corporate governance mechanisms that provide protection of the interests to the new shareholders (Shleifer and Vishny, 1997). Corporate governance mechanisms assure investors in corporations that they will receive adequate returns on their investments. If the required mechanisms are not in place or do not function properly, outside investors will not purchase their equity securities. This is because foreign investors need the assurance that the governance practices at both the firm and country level are good and transparent before they are prepared to put their capital at risk. Recent studies indicate that the quality of governance system can affect the inflow of foreign investments. La Porta et al. (2000) suggest that a sound corporate governance framework in terms well defined investor protection and transparent disclosure increases foreign investors' willingness to provide debt and equity financing as they are more vulnerable to information asymmetry compared to domestic investors. Shleifer & Vishny (1997) also found that good governance in the form of better minority shareholder protection will be likely to lower the costs of capital for firms. Good investor protection also appears to encourage cross-border merger and acquisition activity. For example, Aggarwal et al. (2005) and Rossi and Volpin (2004) offer evidences that that the volume of cross border M&A activity and takeover premiums increases in countries with stronger shareholder protection and stronger accounting standards, shareholder rights and legal standards. Taken together, the above studies find that good corporate governance characterised by predictable, transparent and stable investment environment is essential for establishing an attractive investment climate. A 2010 report produced by the Asian Corporate Governance Association (ACGA) ranked Malaysia 6<sup>th</sup> among 11 countries in Asia, behind Singapore, Hong Kong, Japan, Taiwan and Thailand. The implication for Malaysian companies is that if they wish to attract

more foreign capital, they must ensure that the quality of their corporate governance mechanisms is on par or even exceeds that of its Asian neighbours.

The aim of this paper is to investigate the corporate governance mechanisms in Malaysian and determine the special characteristics of Malaysia firms in terms of ownership structure and how this affects FEO. The second is to test whether firms' with good corporate governance are better able to attract foreign capital inflow. Prior studies suggest that corporate governance is expected to positively affect equity participation of foreign investors (Dahlquist & Robertsson, 2001). To test the relationship between foreign equity ownership and corporate governance, we use firms' level data and examine a number of key corporate governance variables. As our main corporate governance variables, we use insider ownership, proportion of non executive to executive directors to capture monitoring activities and government ownership. In this study, we also use three control variables comprising of firm size, dividend yield and Tobin's Q.

The paper proceeds as follows. The next section reviews the literature on Corporate Governance practices and ownership structure in Malaysia. The description of the dependent and independent variables, development of hypotheses and research method is outlined in Section 3. Section 4 presents empirical results and interpretations. The final section presents the summary and conclusions.

## 2. Literature Review

### Corporate Governance and Ownership Structure in Malaysia

The Malaysian system of corporate governance system is based on the Anglo Saxon model found in the US and UK where boards operate at the single tier level. Under this system executive and non-executive director's sit together to address agency issues such as maximizing shareholder's value and protection of shareholder's interest. In terms of regulation, Corporate Governance in Malaysia is based on the Malaysian Code on Corporate Governance (MCCG) which was formulated in 2000 and applies primarily to boards of listed companies. The Code draws heavily from the recommendations of the Cadbury Report (1992) and the Hampel Report (1998) and incorporates best practices for areas covering the integrity of the company's financial reporting, composition of the audit, remuneration and nomination committees, qualification of directors and the equitable treatment of shareholders and stakeholders. Malaysia has adopted a hybrid approach where MCCG sets standards for desirable practices for publicly listed companies (PLC) to follow, but

companies are given the flexibility to develop their own approach in implementing best practices. When best practices are not complied with, PLCs must give reasons for the non-compliances in their annual reports and the steps taken to ensure future compliance.

Although the Malaysian system of Corporate Governance is very similar to the UK model, there are significant differences between the two countries' corporate governance systems in terms of the way in which ownership and control are organized. In Malaysia, the controlling shareholders tend to comprise of the government, private institutional investors and 'insiders'. For this type of ownership structure, agency problems arise because of conflicts in interest between controlling shareholders and weak minority shareholders (Claessens, Djankov, & Lang, 2000; Mohd Ghazali and Weetman, 2006). Hence, corporate governance systems in Malaysia need to address the problem of 'insiders' withholding private information from outside minority shareholders and using this information for their personal gain (Shleifer and Vishny, 1997). In contrast, equity ownership in UK companies is widely dispersed and with conflicts arising between strong managers and weak shareholders (Filatotchev & Bishop, 2002). The lack of monitoring by weak shareholders of UK companies allows managers the opportunity to expropriating or misallocate corporate resources for their own private advantage (Schiehll, 2006).

Insider ownership represents the percentage of shareholdings of all the directors in the company. The annual reports of listed companies in Malaysia provides information on the percentage holding of the top 30 shareholders, as well as percentage holding by individual directors. This is used to compute the percentage of insider ownership. Empirical findings show that insider directors with high ownership display a greater tendency to expropriate firm wealth for their private benefit (Schiehll, 2006). It has also been argued that a lower incidence of insider ownership leads to improved governance quality in terms of less earnings management (Brennam & Franks, 1997) and more transparent reporting (Tam and Tan, 2007). It is argued that the smaller the fraction of shares that is held by insiders, the more difficult it becomes for managers to entrench their control on the firm and perform earnings management. Conversely large outside shareholders provide efficient an effective mechanism for monitoring of firm performance. For example, Mitton's (2002) reports that Malaysia companies that had a greater level of outside ownership experienced significantly better stock price performance during the Asian crisis.

Board composition could be a particularly important governance variable because it will indirectly reflect the role of NED in improving

corporate disclosures. It has been suggested that non-executive directors (NED's) may help to alleviate the agency problem by monitoring and controlling the opportunistic behaviour of management. A non-executive director is a member of the board of directors of a company who does not form part of the executive management team. He or she is not an employee of the company or affiliated with it in any other way. The MCCG (2000) recommends that the board should include a balance of executive directors and non-executive directors (including independent non-executives) such that no individual person or group can unduly influence the board's decisions. The presence of non-executive directors provides a monitoring or oversight function of company management and this may help reduce agency costs (Hermalin and Weisbach, 1991). Non executive directors are more likely to be independent of management's influence and this enables them to act objectively in decisions involving internal controls and corporate governance. Their independence can help to attract outside capital as their presence makes investors feel more confident that their interests are being well protected (Beasley, 1996). A further positive role of non-executive directors is in terms of disclosure quality. For example, a Malaysian study by Haniffa and Cooke (2002) found a significant association between voluntary disclosure levels and NED on the board.

A number of studies have found that government ownership is detrimental to corporate governance and performance. Shleifer and Vishny (1998) suggest that managers in government owned corporations will override governance systems to expropriate firm assets for the benefit of politicians and bureaucrats. This is the "grabbing hand" argument where the State uses firms to pursue its political objectives, while the public pays for losses incurred by non-performing firms. There are also other reasons that explain why government ownership results in poor governance mechanisms. Estrin and Perotin (1991) suggest that firms with the government ownership will not pursue good governance because profit is not the overriding objective. The state will also have political as well as social objectives such as creating employment opportunities, refraining from closing down loss-making subsidiaries, retrenching staff and pursuing projects to achieve social objectives. Additionally because the firm is run by government appointed representatives, executive compensation and incentive payments are not related to firm performance. Hence there is no personal incentive for managers to ensure that the organization is run efficiently or well governed.

La Porta et al (1999) found that from a corporate governance standpoint, larger firms displayed greater separation of the ownership and control functions. Additionally bigger companies

tend to be more mature with established governance structures in terms of audit committees and outside directors represented on the board of directors (Khanchel, 2007). Larger companies generally have lower levels of information asymmetry regarding their governance mechanisms, command more analyst coverage and are generally more attractive to institutional investors (Bushee & Noe, 2000). This is further supported by Dahlquist and Robertsson (2001) who document that foreign investors in Sweden prefer large companies because information about them is more readily available. In summary, because larger firms adopt better corporate governance systems, this tends to lower monitoring cost by outside investors and attract greater investment.

While dividends payout functions as a signal of company value (Olhson, 1995), prior studies have also found that low dividend payouts are indicative of governance problems (Kalcheva & Lins, 2007). La Porta et al (2000) found that minority shareholders may face expropriation by insiders. To mitigate this problem, Jensen (1986) proposes the payment of dividends to shareholders instead of using it for unprofitable projects. Therefore dividend payout has a positive impact on protection of minority shareholders. It is has also been found that firms that pay higher dividends come under greater scrutiny by the capital markets. Greater monitoring by the market helps alleviate opportunistic management behavior and, thus reduce agency cost (Easterbrook, 1984). Thus, the dividend yield ratio can be viewed as a surrogate for of stronger legal protection of minority shareholders.

Tobin's Q is a widely used performance measure to capture the success of corporate governance mechanisms in enhancing shareholder value and to predict the future success of companies. For example, Weir et al (2002) used Q as a proxy for how closely shareholder and manager interests were aligned. They found that the value of Q increased for firms with more effective the governance systems. Lemmon and Lins (2003) further found that Tobin's Q falls for firms in which minority shareholders are subject to expropriation. In analysing the effect of cross-border mergers on corporate, Bris et al and (2008) found that the Tobin's Q of an industry increased when firms within the industry were acquired by foreign firms with better and more efficient corporate governance. McConnell and Servaes (1990) provided evidence of a positive correlation between shareholdings held by large investors and corporate performance based on Tobin's Q, and further concluded that institutional investors are more

effective in monitoring manager performance than individual shareholders. The improvement in monitoring of manager behavior has the effect of forcing them to act in the interest of outside shareholders.

In summary, one of the objectives of good corporate governance is to overcome the inherent conflicts of interest between minority shareholders, majority shareholders and management (Young, et al, 2002). Conflicts of interest may arise when the governance environment allows controlling shareholders and management to withhold information or expropriate wealth from the minority investors. Good corporate governance can help to ensure that the rights of both minority and majority shareholders are well protected. In Malaysian firms, since foreign equity owners tend to be the minority shareholders, the threat of expropriation of firm wealth by insiders and the majority could be one reason why Malaysia lags behind its Asianneighbours in attracting foreign equity participation.

### 3. Data and Method

#### 3.1 Sampling Procedure and Data Collection Method

The sample in this study consists of 317 Malaysian listed firms over the period 2005-2009. Data was collected from two separate sources: Bursa Malaysia library and annual reports. The Bursa Malaysia database was used to retrieve information on domestic and foreign equity ownership. Information on the board of directors and the financial accounting data was obtained from the annual report. In order to test the relationship between the variables of corporate governance and FEO, we use multiple regression analyses.

#### Empirical Model and Proxy Variables

Prior studies indicate that weak governance systems in terms of investor protection may hinder the inflow of capital to companies. We hypothesize that foreign investors are likely to avoid poorly governed firms because their capital is at risk. Specifically, we maintain that because foreign investors tend to be the minority owners, they face expropriation of their assets by the majority. We use a firm-level cross-sectional data and employ multiple regression analysis to test the relationship between Foreign Equity Ownership and six proxies for Corporate Governance. This is represented by the following equation:

$$\text{Foreign Equity Ownership (FEO)} = \alpha_0 + \alpha_1 X_1 + \alpha_2 X_2 + \alpha_3 X_3 + \alpha_4 X_4 + \alpha_5 X_5 + \alpha_6 X_6$$

where,

FEO =  $\frac{\text{Average Share Price } i \times \text{Total Shares Issued } i \times \% \text{ of Foreign Ownership}}{\text{Total Market Value of FEO}}$

and,

Average Share price  $i$  - average share price for firm  $i$  for the whole financial year.

Total Share Issued  $i$  - total ordinary shares issued by firm  $i$  in the market.

% of Foreign Own  $i$  - percentage of ordinary shares own by foreigners in firm  $i$ .

Total Market FEO - the total market value (in terms of RM) of foreign equity investment in Malaysia and which includes Equity Capital & Reinvested Earnings.

To capture firm level corporate governance attributes we use six endogenous variables identified by many researchers as good proxies for qualities of corporate governance.

These variables include:

i) Insider Ownership (IO):

**$H_1$ : There is a negative relationship between FEO and Insider Ownership.**

ii) Non- Executive Directors Proportion (NED):

**$H_2$ : There is a positive relationship between FEO and NED proportion.**

iii) Government Ownership (GO):

**$H_3$ : There is a negative relationship between FEO Rate and Government Ownership.**

iv) Firm size (FS):

**$H_4$ : There is a positive relationship between FEO Rate and Firm Size.**

v) Dividend Yield (DY):

**$H_5$ : There is a positive relationship between FEO Rate and Dividend Yield.**

vi) Tobin's Q (TQ):

**$H_6$ : There is a positive relationship between FEO Rate and Performance.**

**Table 1.0.** Independent Variables and Expected Sign

Independent Variables	Formula	Expected sign
Insider Ownership ( $X_1$ )	Percentage of total directors' shareholding	negative
NED Proportion ( $X_2$ )	$\frac{\text{Numbers of Non-Executive Directors}}{\text{Total Numbers of Directors}}$	positive
Firm Size ( $X_3$ )	Log10 Assets Value	positive
Government Ownership ( $X_4$ )	1 or 0	negative
Dividend Yield ( $X_5$ )	$\frac{\text{Total Payout Dividend}}{\text{Average Share Price}}$	positive
Tobin's Q ( $X_6$ )	$\frac{\text{Market Value of the Issued Shares}}{(\text{Book Value of Total Assets} - \text{Total Liabilities} - \text{Minority Shares} - \text{Preference Share})}$	positive

The governance variables are shown in Table 1.0 together with their predicted relationship with FEO. The predicted direction of the linear relationship between the six governance measures with FEO is based on prior studies highlighted in the literature review, with a positive sign indicating that the FEO is increasing for firms with better governance and a negative sign denoting an inverse relationship.

#### 4. Analysis and Discussion

Based on the regression results obtained from SPSS and after filtering, normality tests, multi-collinearity tests, the coefficients and regression outputs are shown below:

**Table 2.0.** Results of Regression Model

Dependent Variable	Foreign Equity Ownership			
	Independent Variable	Coefficients	t-statistics	Probability
Insider Ownership ( $X_1$ )		-0.000620	-2.417	0.016
NED to ED Proportion ( $X_2$ )		-0.000085	-0.249	0.803
Government Ownership ( $X_3$ )		0.001424	-6.683	0.000
Firm Size ( $X_4$ )		-0.001096	17.022	0.000
Dividend Yield ( $X_5$ )		0.005199	3.255	0.001
Tobin's Q ( $X_6$ )		0.000763	28.862	0.000

<b>R-squared</b>	<b>0.783</b>
<b>Adjusted R-squared</b>	<b>0.778</b>
<b>F-statistic</b>	<b>185.449</b>
<b>N</b>	<b>317 companies</b>

The *F*-statistic is significant with a value of 185.45 (*F* critical value is at 5% significance, two-tailed test). The *t* test indicates that five governance measures are significant at the 5% level. These measures are insider ownership, firm size, government ownership, dividend yield and Tobin's *Q*. Model fit is also strong with the regression equation explaining 78% ( $R^2$ ) of the variability in FEO. The high degree of association between FEO and suggests that improvements on corporate governance attract more foreign investments.

Insider ownership has an inverse relationship with FEO. This is consistent with  $H_1$ , which stated there is a negative relationship between FEO and insider ownership (Mitton 2002). Firms where directors hold a higher percentage of the issued ordinary shares display a lower ability to attract foreign investors. This is because a higher incidence of insider ownership leads to reduced governance quality in terms of aggressive earnings management (Brennam & Franks, 1997) and less transparent reporting (Tam and Tan, 2007).

While Government Ownership is predicted to have a detrimental effect on FEO, our results show a positive influence. Why FEO increases in government owned companies could be due to the preferential treatment that some government linked companies enjoy in Malaysia. This preferential treatment could take the form of biases in allocating contracts and securing faster approval for regulatory applications such as business licenses and permits. Certain industries in Malaysia are also protected by the Government through the imposition of tariff and non-tariff barriers. Additionally for some companies in key industries such as Banking, Automotive or Airlines, the Government has introduced legislation restricting foreign equity ownership. The Malaysian Government may also choose to hold a 'golden share' in these companies which effectively gives them the power to veto any decisions made by the company. Thus, the preference for foreign investors in Government linked companies might have less to do with good governance, but influenced more by the protectionism and unfair competitive advantage to them.

The results further indicate that although size is a significant variable, foreign ownership is lower in smaller firms. This is in contrast to previous studies that document a positive relationship (Dahlquist and Robertson, 2001). A possible explanation for the inverse relationship is that small firms could be easier to understand and monitor and have better growth opportunities (Evans, 1987). In contrast,

larger firms would have potentially larger agency problems in terms of monitoring cost. Hence, foreign investors tend to underweight larger firms in their portfolio selection.

Although Dahlquist and Robertson (2001) reports that foreign investors in Sweden prefer firms that pay low dividends, the opposite appears to hold for Malaysia. Our results indicate a positive relationship between dividend yield and foreign equity ownership. This supports the Easterbrook (1984) argument that external shareholders exert pressure on firms to pay out dividends to minimize misallocation of firm resources by insiders. Thus, dividend payout can serve as an effective governance mechanism for the protection of minority interest.

## 5. Conclusion

A limitation of this study is that although the results indicate that there is significant causal relationship between foreign equity ownership and good corporate governance, the cause and effect issue is not clearly addressed. It could also be argued that it is the foreign equity ownership variable that is the contributing to good corporate governance and not vice versa. For example, foreign investors through their voting power can push for superior governance practices to be adopted by the company. Therefore, further research could be done in this area. An added complication is that it is difficult to measure the quality of corporate governance at the firm level. The study has utilised six proxies for corporate governance derived from the annual report of listed companies. However, these measures are not exhaustive and the study acknowledges that other governance measures such as transparency in reporting, internal control systems, qualification and experience of directors and number of board meetings may also be correlated with good governance practices, but were not included in the study.

This paper has examined the impact of various corporate governance variables upon the foreign equity ownership in a sample of Malaysian publicly listed companies. We find that good corporate governance increases the foreign equity participation in local companies. In the past, foreign equity participation in Malaysian companies was restricted to 30%. To keep in step with the global trend towards liberalization of economies and compete for foreign investment, the Malaysian Government has relaxed the foreign shareholding cap in a number of industries. For example foreign

investors can now hold 100% of the equity of companies in the manufacturing and hotel industry. Additionally, overseas investors can now hold 70% of the equity of insurance companies and investment banks. The conclusion that can be drawn from this study is that FEO is not only influenced by macro factors such as government incentives, efficient legal systems and political stability, but is also dependent on firm level governance. The results suggest that if Malaysian companies intend to improve their access to foreign capital, it is in their best interest to adopt better governance mechanisms. Companies having superior governance systems in place are likely to enjoy a competitive advantage in terms of attracting more foreign equity capital.

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