A CRITICAL REVIEW OF CORPORATE GOVERNANCE REFORMS IN MALAYSIA

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Abstract

Following the East-Asian financial crisis in 1997 and the corporate accounting scandals, the shareholder's confidence in the audited financial statements was adversely affected and regulators started to think seriously reforming the existing corporate governance practices. As a result, numerous initiatives were implemented to accelerate improvement of corporate governance practices. One of these initiatives was the Malaysian Code on Corporate Governance (MCCG). The code was derived from the approach applied by the British Hampel Committee, which attempt to mitigate the agency problem between corporate managers and outside owners. This study suggests that the British approach is unsuitable to Malaysian business environment. Particularly, the MCCG that had been lunched since 2011 ignore the uniqueness of Malaysia's capital market, regulation environment and ownership structure. Therefore, the study recommends that policy makers and other regulators should consider the local business environment when establishing future code on corporate governance.

Keywords: Agency Problem, Codes of Good Governance, Malaysia

1. INTRODUCTION

The objective of this study is to assess the suitability of the Cadbury Report to Malaysian business environment. An important debate in the literature is whether "comply or explain" voluntary approach, such as the Cadbury report in the U.K, or whether the Sarbanes- Oxley Act 2000 in the U.S, are effective in improving corporate governance structure and mitigate the agency problem. In Malaysia, the Asian economic crisis in 1997/1998 as well as the highly-publicized scandals around the world revealed the urgent need for companies to enhance corporate governance mechanisms in order to restore shareholders' confidence in the reliability of accounting information (Hashim & Devi, 2008). As a result, Malaysian regulators launched the Malaysian Code on Corporate Governance (MCCG).

Originally, the code largely followed the Anglo-American approach in the United Kingdom, essentially drawn from the recommendations of the Cadbury Report (Liew, 2008). These recommendations focus on strengthening the role of non-executive directors. This is accomplished by imposing strict rules regarding independence of non-executive directors, creation of numerous committees comprised solely of non-executive directors, having a senior independent director of a board to whom all matters can be directed, and also that outside independent directors are at least as numerous as executive ones (Zalewska, 2014).

According to listing requirements of the Bursa Malaysia, firms are obliged to disclose information annually based on the rule of the "comply or explain" voluntary approach by which they must explain the extent to which they have complied to best practices and also must clarify any conditions justifying departure from any non-compliance (Aguilera & Cuervo-Cazurra, 2009; Securities Commission, 2000). The logic underlying the above position is that one-size-fits-all is not necessarily the optimal choice for a firm and what are the exact conditions that have led to non-compliance (Arcot, Bruno, & Faure-Grimaud, 2010). In the same vein, the code encourages firms to adopt the spirit of the best practices instead of simply satisfying the minimum requirements or "box ticking" behaviours for which the latter may fail to allow for sound deviations from recommendations in the code (Arcot et al., 2010; Leong, 2013).

The code was revised several times to improve the effectiveness of audit committee and board of directors. The last time was when the former Vice-President of the Malaysia Institute of Corporate Governance, Tan Sri Lau Ban Tin, called for a more effective Corporate Governance Code as highly publicized scandals still overwhelmed the business environment in Malaysia (Governance Newsletter, 2010). Then, the Malaysian Securities Commission issued its Corporate Governance Blueprint 2011, which spelled out the Commission's outlines for enhancing governance regulatory structures over the coming five years (Governance Newsletter, 2011).

One of the most important deliverable of the Corporate Governance Blueprint 2011 was the Malaysian Code on Corporate Governance 2012 (MCCG 2012). The MCCG 2012 introduces new provisions whose purpose is to improve the effectiveness of the board of directors through strengthening its composition and independence as well as recognising the role of directors as active and responsible fiduciaries. The code comprised of 8 principles and 26 recommendations on good corporate governance.

Basically, each principle in the code is followed by recommendations and commentaries that attempt to demonstrate and help firms understand the recommendation. The principles incorporate wide concepts regarding effective corporate governance that firms are expected to apply when implementing the recommendations. The recommendations are specific standards that help firms to achieve the principles. The principles under current code include: establishing clear roles and responsibilities, strengthening composition, reinforcing independence, fostering commitment, upholding integrity in financial reporting, recognising and managing risks, ensuring timely and high-quality disclosure and strengthening the relationship between company and shareholders (Securities Commission, 2012).

The new code seems to rely more on statutory law and Bursa Malaysia listing requirements to implement its principles and recommendations. Specifically, several key recommendations aligning with the CG Blueprint 2011 and MCCG 2012 have been implemented through changes made to Bursa Malaysia Listing Requirements while others require changes to the law (Yit, 2013). With respect to content, the new code adopts some of the best practices of the 2007 revised code and also introduces additional principles and recommendations to increase the effectiveness corporate governance. These principles and recommendations are discussed below.

1. Responsibilities and roles of the board. The new code requires corporate boards to institute ethical standards through code of conduct and ensure the implementation of relevant internal mechanisms to ensure strict compliance with all provisions of the code. To achieve this, attention has to be given to the environmental settings and the social and governance characteristics of business and it policies for improving sustainability. Moreover, companies are encouraged to enact board charters and ensure their periodic review. The charter has to include important features of the company's primary values. Division of powers and responsibilities of the board and management should also be included in the charter including established committees, and responsibilities of the chairman and the CEO.
2. Strengthening of the board's composition. MCCG 2012 recommends the establishment of a nominating committee, exclusively comprising non-executive directors, and the majority of them must be independent. The nominating committee should be responsible for developing, maintaining and revisiting the criteria to be adopted for recruitment and the director's annual assessment and selection of suitable females who will sit on the company's board. In addition, the code mandated the creation of a committee to establish proper and transparent compensation policies that will attract new and retain existing directors.
3. Reinforce Independence. Different persons must hold the chairman and CEO positions, and the chairman of the board must be a non-executive board member. Also, the tenure of independent directors must be capped for an accumulative period of nine years. After completing the nine-year period, the director may remain in the company as a non-independent director after retention has been justified and with owners' approval.
4. Foster commitment. The code requires the board to map out expectations in a timely manner the obligations for membership and procedures for accepting new director. Directors are required to notify the board chairman before accepting a new directorship appointment. Such notification must include the time commitment expected of him/her in the new appointment. The Nominating Committee is required to consider such new appointments during the annual director's assessment.
5. Timely and high qualitative disclosure. The board is required ensure the firm has appropriate corporate disclosure guidelines and procedures. These guidelines and procedures must be practical and should include response from management to ensure strict compliance with the corporate disclosure requirements set out in the listing requirements of the Bursa Malaysia.
6. Association between firm and shareholders. The board should boost shareholder participation in the general meetings and resolutions by improving voting rights. The chairman of the board should notify shareholders of their voting rights at the start of the general meeting. The board is also encouraged to put in place substantive resolutions to vote by way of polls and make announcements of the comprehensive results displaying the number of cast votes for and against every resolution.

2. THEORETICAL BACKGROUND

2.1 Agency theory

Agency theory provides the theoretical support for the most accounting studies (Jensen & Meckling, 1976). The theory attempts to explain the relationship between shareholders and managers (Godfrey, Hodgson, Tarca, Hamilton, & Holmes, 2010). An agency relationship is established when shareholders employ managers to perform duties on their behalf (Kirby & Davis, 1998). However, due to the separation of ownership and management in corporate organizations, the relationship between inside managers and outside shareholders is fuelled with conflicting interests (Dey, 2008). For example, managers may not always act in the shareholders' fundamental interests. They could pursue their own private incentives when opportunities arise at the expense of shareholders (Florackis & Ozkan, 2009).

These conflicting interests, commonly known as agency problem, arise from two main sources. First, managers and shareholders have different objectives and interests (Gillan & Starks, 2003). Second, they have incomplete information as to each other's behaviors, knowledge and interests (Gillan &

Starks, 2003). These issues lead to agency costs that are defined as a reduction in shareholder wealth, resulting from the differences in interests between managers and shareholders (Godfrey et al., 2010). Farber (2005) notes that, as there is a separation of ownership and management, agency costs will continue to persist over time in organizations.

To reduce some agency costs, both managers and shareholders have incentives to enter into contracts delineating their relationship with the firms(James, How, & Verhoeven, 2008; Watts & Zimmerman, 1979). Examples of contractual agreements include debt covenants and management compensation agreements (Fields, Lys, & Vincent, 2001). These contracts are often linked to accounting amounts such as earnings (Ronen & Yaari, 2008). Unfortunately, contracting alone cannot prevent all unethical activities by managers (Watts & Zimmerman, 1990). Specifically, managers may use their discretion offered in accounting standards to alleviate the constraints imposed by these contracts, resulting in accounting information that does not reflect the underlying economic performance of the firm (Warfield, Wild, & Wild, 1995).

Based on the above discussion, the relationship between top managers and shareholders is filled with conflicting interests resulting from the separation of ownership and management, the differing objectives of top managers and investors, and information asymmetry between less informed investors and more informed executives (Dey, 2008). Managers may employ their accounting discretion opportunistically to achieve some of their own private incentives (Roychowdhury & Martin, 2013). This motivates shareholders to set up mechanisms in order to prevent undesirable managerial activities (Jensen & Meckling, 1976). As a consequence, corporate governance is designed to mitigate the potential conflicts between the managers and shareholders and to lower the agency costs for all parties (Fama & Jensen, 1983; Jensen & Meckling, 1976).

2.2 Application of Agency Theory in the Malaysian Context

Importantly, however, the traditional agency theory is inapplicable in the Malaysian context Htay, Salman, & Shaugee (2013). That is, the extent of ownership concentration affects the nature of the relationship between owners and managers (Fan & Wong, 2002). More precisely, as outside ownership increases, owners may gain effective control of a company. Therefore, the nature of the agency problem shifts away from the traditional conflict of interest between shareholders and managers to a conflict between majority and minority shareholders (Fan & Wong, 2002). In other words, if a small group of owners with majority ownership dominates control of the company's management, then the possibility of the majority shareholders utilizing earnings management to camouflage company earnings and to expropriate the best interests of minority shareholders is high (Chen & Zhang, 2014; Jaggi, Leung, & Gul, 2009). By contrast, when the ownership is diffuse, as in Western countries, agency theory is rooted mainly in the conflict of interest between shareholders and managers who possess an immaterial amount of outstanding shares (Fan & Wong, 2002; Jensen & Meckling, 1976).

As a result, given that Malaysian companies are characterised by a high level of ownership concentration and the wide prevalence of family-controlled businesses (Liew, 2007; Mustapha & Che-Ahmad, 2011), investors are more likely to be exposed to the Type II agency problem (conflict between majority and minority investors) than the traditional agency problem (conflict between executives and investors) (Jaggi et al., 2009; Villalonga & Amit, 2006). Hence, the conclusion can be drawn from the above discussion that corporate governance in Malaysia is mostly intended to alleviate the conflicts between majority and minority shareholders (Htay et al., 2013).

3. LITERATURE REVIEW

It has been argued that codes on corporate governance are important mechanisms that allow a shareholder to reduce managerial discretion and thus, to increase the reliability of financial statements (Alonso-Paulí & Pérez-Castrillo, 2012; Chen & Zhang, 2014). The corporate governance literature reinforces such arguments by showing evidence that corporate governance codes mitigate earnings management, improve financial reporting quality, and increase firm value (Chen & Zhang, 2014; Cohen, Dey, & Lys, 2008; Dahya, Mcconnell, & Travlos, 2002; Ghosh, Marra, & Moon, 2010; Peasnell, Pope, & Young, 2000).

Of the literature particularly related to this current study is Peasnell et al. (2000) work that examined the impact of Cadbury Committee Report (1992) on the association between accrual-based earnings management and board composition. While they failed to find evidence of a significant association between the board composition and the level of earnings management in the pre-Cadbury period, they found a significant negative association between the proportion of outside board directors and income-increasing accruals in the post-Cadbury period. The authors suggested that directors on the boards performed their duties more effectively after the implementation of Cadbury Report. In a related study, Dahya et al. (2002) examined the impact of the Cadbury report on the relationship between firm performance and top management turnover. Their findings were consistent with the notion that firms adopting the Cadbury recommendations exhibited greater sensitivity in the relationship of performance to top management turnover.

In China, Chen and Zhang (2014) examined the effectiveness of the voluntary 2002 Chinese Code of Corporate Governance for Listed Companies on curbing opportunistic earnings management. The study reported that the code improved the effectiveness of the corporate governance mechanisms in constraining earnings management. Moreover, the authors found that the code had greater positive impact on privately controlled firms as compared to state-controlled firms. Their study recommended additional ownership structural reforms to improve corporate governance in China.

In Mexico, Machuga and Teitel (2007) examined whether the implementation of the 2000 Mexican Corporate Governance Code improved earnings quality. They found improvement in earnings quality subsequent to the introduction of the code employing several metrics for earnings quality. These metrics include conditional accruals, timely loss recognition and income smoothing. In another study, Machuga and Teitel (2009) found no improvement in earnings quality for firms having shared directors and concentrated family ownership after the implementation of Mexican Corporate Governance Code. They suggested that applying governance reforms, without considering country specific legal and business environments might impede the achievement of the desired goals of changes.

In Malaysia, previous studies investigated the impact of MCCG on disclosure quality, firm performance, and earnings quality (Abdifatah, 2014; Abdul Wahab, How, & Verhoeven, 2007; Lim, Ismail, & Eze, 2013; Lim, How, & Verhoeven, 2014; Salleh & Haat, 2013). However, none of these studies investigated data during the pre- and post-MCCG 2012 regimes. For example, Abdul Wahab et al. (2007) found improvement in disclosure relating to corporate governance practices and the role played by institutional investors in ensuring governance quality in the post-MCCG regime. Furthermore, they found that the introduction of MCCG 2000 led to a 5% increase in stock price performance.

In a related study, Salleh and Haat (2013) compared the association between audit committee diversity and accrual-based earnings management between the pre- and post-revised MCCG regimes. The study presented evidence that the mere existence of Malay directors on audit committee was negatively related with earnings management during the post-revised MCCG regimes. Abdifatah (2014) found that, except for the number of board meetings, none of corporate governance variables exhibited a significant association with firm performance between the pre- and post-revised MCCG regimes. He suggested that the code on corporate governance was inappropriate for the Malaysian corporate environment because it was initially adopted from country with different institutional settings.

Overall, previous studies in Malaysia are inconsistent and provide limited evidence on whether MCCG 2012 provides positive impacts for shareholders. This study adds to the existing literature by exploring the appropriateness of the code on corporate governance to the capital market in the country characterized by its unique institutional settings.

4. MAIN CHALLENGES AND CRITICS TO CORPORATE GOVERNANCE REFORMS IN MALAYSIA

Capital markets in Western countries, such as those that generally exist in United Kingdom and the United States are characterised by diffused ownership (Hashim & Devi, 2008). The shareholders may neither have enough equity ownership nor expertise in directing the firm activities. Hence, corporate managers are considered to be the best persons to manage the firm (Salim, 2006). However, while the primary interest of shareholders is to maximize return on assets and share return, managers have a broad range of interests, such as bonus compensation, prestige and other needs (Wolk, Dodd, & Rozycki, 2013). Therefore, an agency problem arises mainly from the conflict of interests between outside shareholders and inside managers (Ching, Firth, & Rui, 2006). To minimize these conflicts, agency theory recommends establishing internal and external governance mechanisms (Tariq & Abbas, 2013). A major problem of corporate governance in Western countries is to mitigate the conflict between dispersed shareholders and powerful managers (Enriques & Volpin, 2007).

In contrast, Malaysian companies are characterised by a high level ownership concentration and the wide presence of family-controlled business (Claessens, Djankov, & Lang, 2000; Salleh & Stewart, 2012). The main agency problem emerges as a consequence of the conflicting interests between controlling shareholders and minority shareholders (Claessens & Fan, 2002). If a small number of owners effectively control the firm, then the risk of expropriating the best interests of minority shareholders by majority shareholders is high (Ching et al., 2006). This control is further facilitated through pyramid schemes or cross shareholding between firms (Chen, 2013) . Under such conditions, the divergence between control and cash flow rights is significant (Ow-Yong & Guan, 2000). Therefore, corporate governance in Malaysia is seen as an important mechanism to prevent dominating shareholders from engaging in activities that are detrimental to the best interests of minority shareholders (Liew, 2008). In line with this argument, Tam and Tan (2007) argued that protecting the interests of minority shareholders remains a crucial issue to be solved in Malaysia because controlling owners continue to exert their power via ownership concentration and participation on the board of directors.

Furthermore, it has been argued that many politically favored firms and destructive nepotism and cronyism exist in Malaysia (Chen, 2013; Gul, 2006; Vithiatharan & Gomez, 2014). For example, Liew (2007) claims that special privileges and exemption from rules and regulations have been given to politicians and political-related parties. When political interests interfere with corporate decisions, the wealth of minority shareholders may be harmed (Salim, 2006). The obvious implication is that strong enforcement of corporate governance reforms is unlikely to occur in an environment in which significant political influence on firms is present (Liew, 2007).

To reform the capital markets in Malaysia, the MCCG focuses on strengthening the position of non-executive directors by imposing the rigorous independence of outside directors. However, the effectiveness of independent non-executive directors remains doubtful. Given high ownership concentration in Malaysia, the power of the board of directors is derived from controlling owners. Hence, expecting the board to challenge controlling investors is unrealistic. This, in turn, will decrease the effectiveness of the board of directors (Rajagopalan & Zhang, 2008).

The main reason for the ineffectiveness of corporate governance reforms in Malaysia is that many initiatives have been primarily based on Anglo-American regimes, which are unsuitable for the local context (Liew, 2007, 2008; Vithiatharan & Gomez, 2014). This is because the differences in the ownership structure, as well as cultural and political environments, denote that the root of the problems and solutions to them differ across nations (Salim, 2006). For example, the traditional conflict between owners and managers in an Anglo-Saxon environment may not be a concern in the capital market in which the excessive powers of dominating owners create the major agency problem (Salim, 2006).

Globalisation or more particularly, global capitalism was the invisible hand behind corporate governance reforms in Malaysia (Liew, 2008). This fact is corroborated by anecdotal evidence from former Malaysian Prime Minister, Mahathir Mohamad, who stated" we try to follow [the IMF programmes] not because we think the IMF is right, but because if we don't then there will be a loss of confidence….So we try to show that we are with the IMF"(Shameen & Oorjitham, 1998, p. 4) as cited from (Liew, 2008).

In summary, the nature of the corporate governance problems may vary from country to country. Hence, policy makers should note that applying governance reforms without considering the country-specific legal and cultural environments may impede the achievement of the desired goals of changes (Machuga & Teitel, 2009).

5. CONCLUSION

In Malaysia, corporate governance has been enhanced recently through the promulgation of the MCCG 2012, as a consequence of a series of corporate scandals that continued to occur in the Malaysian business environment (Governance Newsletter, 2010). The main objectives of MCCG 2012 were to strengthen board structure and composition, recognize the role of directors as active and responsible fiduciaries, enhance the integrity of the financial statements, and respect shareholders' rights (Securities Commission, 2012). Notwithstanding that MCCG 2012 includes significant changes (The Star News, 2012), several prior studies argue that the impact of those changes is questionable as the code largely followed the Anglo-American approach in the United Kingdom (primarily from the recommendations of the Cadbury Report) that may not provide solutions to local problems (Htay et al., 2013; Vithiatharan & Gomez, 2014).

In conclusion, we suggest that corporate governance in Malaysia constitutes mere cosmetic alterations and nothing more than "box ticking" behavior to satisfy legal requirements. An important policy implication of our study is that further corporate governance reform is needed to mitigate agency problem in Malaysia. This is important as there are growing pressures to enhance corporate governance structures in developing countries to line with international standards.

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