

**CORPORATE GOVERNANCE AND COST OF EQUITY
IN MALAYSIA**

ROSLIZA BINTI RAMLI

*Research report submitted in partial fulfilment of the requirements for the degree
of Master of Business Administration*

2011



**GRADUATE SCHOOL OF BUSINESS (GSB)
UNIVERSITI SAINS MALAYSIA**

DECLARATION

I hereby declare that the project is based on my original work except for quotations and citation which have been duly acknowledged. I also declare that it has not been previously or concurrently submitted for any other degree at USM or any other institutions.

(Signature):

Name : ROSLIZA BINTI RAMLI

Date :

ACKNOWLEDGEMENTS

There are many individuals whom I would like to thank for their underlying support and guidance that made it possible for me to complete this MBA project paper.

First of all, my sincere gratitude goes to Public Service Department of Malaysia for the financial support of my study. Special thank is due to my department, Valuation and Property Services Department, Ministry of Finance Malaysia for giving me an opportunity to continue my study.

I am greatly indebted to my supervisor and co-supervisor, Dr. Effiezel Aswadi Bin Abdul Wahab and Professor Datin Ruhani Binti Ali for their continuous support, stimulating suggestions, encouragements, feedbacks, constructive criticism and patience toward me in providing much-needed assistance in all time of research for and writing of this thesis. Truly, from the bottom of my heart, it is really my honor to have them as my supervisors.

My final and largest debt goes to my beloved family, to my parents for giving me life in the first place and for unconditional support and encouragement to pursue my studies; to my husband for his unremitting love, understanding, patience, support and encouragements which have helped me accomplish my dream, and to my three little kids for their understanding, love, and independence that enabled me to complete this study. My precious thanks are also dedicated to all my friends who have always given me moral support and enthusiasm to complete my thesis, I'm really appreciating it.

TABLE OF CONTENTS

ACKNOWLEDGEMENTS	ii
TABLE OF CONTENTS	iii
LIST OF TABLES	vii
LIST OF FIGURES	viii
ABSTRAK	ix
ABSTRACT	x
CHAPTER 1	
INTRODUCTION	1
1.1 Introduction	1
1.2 Background of the Study	1
1.3 Problem Statement	5
1.4 Research Questions	8
1.5 Research Objectives	8
1.6 Definition of Key Terms	9
1.7 Significance of the Study	10
1.8 Organisation of the Remaining Chapters	11

CHAPTER 2

INSTITUTIONAL BACKGROUND	13
2.1 Introduction	13
2.2 Malaysian Capital Market	13
2.3 Corporate Governance in Malaysia	17
2.4 Institutional Investor	20
2.5 Summary	22

CHAPTER 3

LITERATURE REVIEW	23
3.1 Introduction	23
3.2 Agency Theory	23
3.3 Corporate Governance	27
3.3.1 Board Size	28
3.3.2 Independent Director	30
3.3.3 CEO is Chairman of Board of Director (CEO Duality)	31
3.3.4 Institutional Investor	32
3.4 Cost of Equity	35
3.5 Corporate Governance and the Cost of Equity Capital	37
3.6 Summary	44

CHAPTER 4

CONCEPTUAL FRAMEWORK AND HYPOTHESES DEVELOPMENT	45
4.1 Introduction	45
4.2 Conceptual Framework	45
4.3 Hypotheses Development	47
4.3.1 Internal and External Corporate Governance	47
4.3.1.1 Board Size and Cost of Equity	48
4.3.1.2 Independent Director and Cost of Equity	49
4.3.1.3 CEO Duality and Cost of Equity	51
4.3.1.4 Institutional Investor and Cost of Equity	52
4.4 Summary	53

CHAPTER 5

METHODOLOGY	54
5.1 Introduction	54
5.2 Data	54
5.3 Research Method	56
5.4 Variables Measurement	56
5.4.1 Dependent Variable	56
5.4.1.1 Cost of Equity	56

5.4.2	Independent Variable	60
5.4.2.1	Corporate Governance	60
5.4.3	Control Variables	60
5.5	Summary	64
CHAPTER 6		
RESULTS		65
6.1	Introduction	65
6.2	Descriptive Statistics	65
6.3	Univariate Analysis	69
6.4	Multivariate Analysis	75
6.5	Summary	80
CHAPTER 7		
CONCLUSION		82
7.1	Summary and Conclusion	82
7.2	Implication of the Study	84
7.3	Limitation of the Study	85
7.4	Recommendation for Future Research	86
REFERENCES		88

LIST OF TABLES

Table 5.1	Sample of 2881 firm-year observations for period of 1999-2009	55
Table 5.2	Summary of the operationalisation of variables	63
Table 6.1	Descriptive Statistics sample of 978 Malaysia Public Listed Firms, 1999 to 2009	68
Table 6.2	Pearson Correlation Matrix of Test Variables	73
Table 6.3	Spearman Correlation Matrix of Test Variables	74
Table 6.4	Regression of Cost of Equity for Malaysian Public Listed Firms, 1999 to 2009 (n=978)	79
Table 6.5	Summary of Findings	81

LIST OF FIGURES

Figure 4.1	Schematic diagram for the conceptual framework	46
------------	--	----

ABSTRAK

Kajian empirikal membuktikan bahawa terdapat hubungan antara pembolehubah tadbir urus korporat dan kos ekuiti. Kesan tadbir urus korporat ke atas kos ekuiti adalah sangat penting kepada firma dan juga kepada pelabur kerana mereka akan mendapat maklumat dan gambaran yang lebih baik mengenai keadaan firma mereka dan juga bagaimana pelaburan mereka diuruskan. Kajian lepas menjelaskan dengan adanya tadbir urus korporat yang baik, maka ia dapat mengurangkan kos ekuiti dan dengan itu secara tidak langsung ia meningkatkan keyakinan pelabur dan jumlah saham yang didagangkan. Tujuan kertas ini adalah untuk mengkaji hubungan antara pembolehubah tadbir urus korporat (pemboleh ubah terdiri daripada saiz lembaga, tahap pengarah bebas, fungsi dualiti Ketua Pegawai Eksekutif dan pelaburan daripada institusi) dengan kos ekuiti di Malaysia. Analisis dijalankan ke atas 978 buah firma (2,881 firma dalam tahun pemerhatian) yang tersenarai di Bursa Malaysia meliputi tahun 1999 hingga 2009. Hasil ujian regresi menunjukkan terdapat hubungan signifikan antara tadbir urus korporat dan kos ekuiti terutamanya bagi factor pelabur institusi. Hasil kajian ini juga menunjukkan bahawa firma akan memperolehi manfaat dari tadbir urus korporat yang digunapakai dalam bentuk pengurangan kos ekuiti dan seterusnya dapat membantu perkembangan pasaran modal dan pengagihan sumber dengan lebih efisien.

ABSTRACT

The empirical study proves that there is a relationship between corporate governance variables and cost of equity. The impact of corporate governance to the cost of equity is very important to the firms and also to the investors because they will get better information about how well their company or their investment is managed. The past studies explained that, with good corporate governance, it can reduce the cost of equity, and thus indirectly enhance investors' confidence and the number of shares traded. The purpose of this paper is to examine the relationship between corporate governance variables (board size, level of independent director, CEO duality and institutional investor) and cost of equity in Malaysia. Analyses are conducted on 978 firms (2881 firm-year observations) listed on Bursa Malaysia from 1999 to 2009. Regression test results show that there is a significant relationship between corporate governance and cost of equity only for institutional investor variables. The study also shows that firms are expected to benefit from corporate governance adopted in the form of reduced cost of equity, and thus it can help the development of capital markets and the allocation of resources becomes more efficient.

CHAPTER 1

INTRODUCTION

1.1 Introduction

This first chapter introduces the research outline of the study. The flow of this chapter begins with Section 1.2 by highlighting the background of this study and Section 1.3 the problem statement followed by Section 1.4 research questions, Section 1.5 research objectives and Section 1.6 is discussing about the significance of the study. Finally, in Section 1.7 is a brief of the overview for the remaining chapters in the study.

1.2 Background of the Study

In order to begin this research, it is important to know the overview of the research itself. In today's public corporations, investors and owners do not have total control in spending their money and are not distracted in the process of making decisions. The owners relinquish the control to professional controllers or managers to impose greater control over the resources of a firm. Fundamentally, the ownership of public companies is detached from control. Berle and Means, (1932) define this as leading to conflicts of interest between managers and owners. These conflicts of interest occur when the managers are directly involved in the activities that are inconsistent with the goals of maximizing shareholders' wealth. With the widespread conflicts of interest, it eventually results in minimizing the value of the firm.

From these conflicts of interest, ideas form the starting point for research in corporate governance. Jensen and Meckling (1976) describe in their famous theory of the firm paper, applied agency theory to the contemporary corporation and formally modelled the agency costs of equity. The owners and shareholders need to set up corporate governance to reduce agency's costs evolve from opportunistic behaviour of management and for reducing the adverse effects of an incomplete contracting.

Ibrahim and Abdul Samad (2008), explain the word 'governance' is synonymous with economic organisations and corporations for several decades. With this term being used for a long time and it is extremely important and beneficial to the success of business organisations, at the same time it is also giving good returns for investors. Corporate governance has been explained and there are several control methods such as the structure of the board, managers and boards' incentive compensation, the right decision of the board of directors and chief executive officer, replacing the board of directors and chief executive officer, the voting shareholders, debt/equity finance, exposure on the acquisition and others. Therefore, corporate governance can be considered as a set of how effective the institutions are in managing and making corporate decisions (Ball, 1998).

In order to minimize the agency costs, corporate governance covers a wide range of internal and external mechanisms. This in hand, increase the monitoring management action, restricting opportunistic conduct of managers and improve the quality of firm information flows in the framework of the detachment of ownership and control. No matter how the significance of corporate governance in public companies is widely known, its role in creating value for our shareholders remains distinct. This is generally

normal for the market and the performance of accounting firms. However, there is a brand new show idea in which the firm can also be stand view from the point of the firm's capabilities. Thus it would benefit from a reduced cost of capital (the cost of equity and debt) from an outcome of strong corporate governance mechanisms (Donker and Zahir, 2008).

The problems of current economic conditions affect more companies around the world. Improper corporate governance is said to be the root of the problem. Abdul Wahab *et al.* (2007) describe that in 1997/98, Asian financial crisis has shown that improper corporate governance practices in Malaysia has added to the company's downfall. In 2004, the World Bank (Klapper *et al.*, 2004) carries out a research on corporate governance, investor protection, and performance in budding markets. Klapper *et al.* (2004) find that good governance is associated to the operational performance, measured in return on assets, and market valuation, as measured in the price to book ratio, while those greater correlations strong in countries where legal systems are weak.

Problems occurs between shareholders and managers that expose the agency costs of shareholders created by the separation of ownership and control in corporate organisations due to the imbalance of information. Agency costs arise when managers have their own personal interests at the expense of shareholders, the information asymmetry that will create moral hazard problems. When investors cannot distinguish the true economic value of the firm that is partially a function of the indistinguishable quality of management, so the agency costs will arise. Lack of transparency in decision and risk exposure of financial information in a higher information are imposed on shareholders. Without effective monitoring, transparency of financial information and adequate

control, rational investors will price-protect against expected agency costs, effectively increase the cost of equity capital firms.

Chen *et al.* (2009) state that the correlation between corporate governance and the cost of equity capital using data from 559 firm-year observations across the 17 rising markets are covered in two corporate governance surveys by Credit Lyonnais Securities Asia (CLSA). Chen *et al.* (2009) find a significantly negative relation between a firm's corporate governance and its cost of equity capital after controlling for risk factors, especially among firms in countries with relatively weak shareholder protection.

Corporate governance is a set of system through which external investors can guard themselves against threat by insiders as defined by La Porta *et al.* (2000). The cost of equity of a firm can be reduced using these sets of mechanisms. This is because better corporate governance offers lower price of equity by minimizing the cost of external supervising by external investors (Chen *et al.*, 2009).

According to Lombardo and Pagano (2002), as they need to spend more time and resources on monitoring the firms' managers, outside investors demand a higher required rate of return from firms with poor corporate governance. In addition, corporate governance also lowers the cost of equity by putting limitations for opportunist insiders and thus reducing information asymmetry. In Southeast Asia, better corporate governance is associated with less insider trading (Hung and Trezevant, 2003).

Ashbaugh *et al.* (2004) find that the governance ascribes considerably concerning the firm's cost of equity capital directly. Hence, the objective of this paper is to investigate the area to which corporate governance attributes that are intended to reduce agency problems affect firms' cost of equity capital.

1.3 Problem Statement

Shleifer and Vishny (1997) state that the effect of corporate governance on firm value has a large research interest. There are too many researchers in the field of accounting and finance. It is argued that if a firm entered into a robust governance mechanism, they must be well managed and profitable. Indeed, strong corporate governance is expected to contribute in the overall value creation process.

An upsurge of literature justifies that corporate governance mechanisms such as independent directors, the quality of information disclosure, ownership structure, audit committees and institutional shareholders are able to contribute towards enhancing the performance of the firm [Abdullah (2004); Drobetz *et al.* (2004); Black *et al.*, (2006); Brown and Caylor (2006); and Bauer *et al.*, (2008)].

Apart from market and accounting performance measures of firms, the cost of capital, which consists of cost of equity and debt, is primarily a measure of risk. It is also closely linked with the firm and is often regarded as a key determinant of value. Donker and Zahir (2008) state broadly that sound corporate governance has a positive influence on the cost of capital (the cost of equity and debt). Similarly, the mechanism of strong corporate governance will provide a low risk to the firm as well as low cost of capital. In

the suit it would raise the market value of the firm, a value that will result when the firm can benefit from an economical source of capital. Moreover, the cost of capital (consist of cost of debt and cost of equity) is significant for firms to evaluate future investment opportunities and review existing investments.

Many researchers find that better corporate governance quality is able to improve the firm's access to equity finance thereby reduces a firm's cost of equity capital. Claessens (2003) and La Porta *et al.* (2000), also support that better corporate governance enable the firms to reduce their cost of equity. This may be because the outside might be providing extensive financial and expect a lower rate of return if they are guaranteed a larger return from their investment.

The stipulation of poor corporate governance affects agency costs to firms in the form of investment as incompetent and it is also to some certain limit will affect the funding decision as presented by Gompers *et al.* (2003). Singh (2003) also argues that firms which are more competent and dynamic access the capital from the stock market at low cost, while the firms with less capability and vitality will have to raise capital at higher costs.

Previous literature finds consistent evidence around the world that good corporate governance is associated with higher firm valuation to study the United States (U.S.) (see Gompers *et al.*, (2003) and Aggarwal *et al.* (2005, 2007) for international studies). However, it is not clear why the firm has any interest assessment of good governance practices. It can either be caused by the firm with better governance practice generates higher cash flows to shareholders or they have contacts to external financing at lower

costs that discounts future cash flow less heavily. Hail and Leuz (2006) find that firms from countries with greater disclosure requirements, regulations and high safety of law enforcement have a much lower cost of equity capital. Yavuz (2008) finds investor protection to prevent redistribution of wealth by the management and reduce costs related to the systematic risk of equity.

Cost of equity is the minimum rate of return that a business or organization must offer investors or owners to offset their wait for a return on investment and for assuming some level of risk. Cost of equity is one of the item under company's capital structure, and mostly depends on many factors such as firm performance, financial factors and economic conditions, the board of independent directors, board size, and government policies and regulations. As an investor in the company chosen by the public always has the option to quit taking the decision to sell its shares. With this way, the rules governing the attitude of the business considerations of the court on the separation of management and financing is to keep the courts out of corporate decisions except on matters of executive pay, self-dealing and protection of share of the spoils by (Titman *et al.*, 2010).

The factors of internal and external characteristics of corporate governance in this study are to be discovered on how much it will affect the outcome for the cost of equity. Gupta *et al.* (2010) in his study previously find that the origin of law, financial development and the development and characteristics of firm level governance has affected the cost of equity capital. Another research done by Chen *et al.* (2009) find that the level of corporate governance firms have a large negative impact on the cost of equity capital, especially in countries that provide legal protection for investors is relatively weak. They also concluded that the effects of a strong complementary between firm-level governance

practices and the protection and disclosure laws at the state level in terms of reducing the cost of equity.

This study will examine internal and external factors of corporate governance that influence the outcome of the cost of equity. Thus, the problem statement for this study is to examine the correlations between corporate governance factors and cost of equity.

1.4 Research Questions

With accordance to the purpose, this study will proceed to answer the following questions:

- (a) What is the relationship between Corporate Governance and Cost of Equity?
- (b) What is the effect of internal Corporate Governance to the Cost of Equity?
- (c) What is the effect of external Corporate Governance to the Cost of Equity?

1.5 Research Objectives

Based on the research problems, the main objective of this study is to:

- (a) To investigate the relationship of board size with firms' cost of equity.
- (b) To examine the relationship of independent directors of the firm with the cost of equity.
- (c) To investigate the relationship between CEO duality with firms' cost of equity.
- (d) To investigate the connection of institutional investor with the cost of equity of the public listed firms.

1.6 Definition of Key Terms

In order to better understanding of the concepts, the following key terms' definition are referred specifically.

(a) Cost of equity

Cost of equity is normally used to measure on the returns that the stock market demands for investors. Cost of equity is the required rate of return that a stockholder demands from a publicly-traded company in exchange for buying a share and assuming the risk associated with it (Zorn, 2007). Cost of equity is also include under company's capital structure along with preferred stock, common stock, and cost of debt.

(b) Corporate Governance

Corporate governance refers to the structures and processes for the direction and control of companies. Corporate governance concerns the relationships among the management, board of directors, controlling shareholders, minority shareholders and other stakeholders (Corporate Governance Survey Report, 2006).

(c) Board size

Board size refers to total number of director on board of directors. Based on the Corporate Governance Survey Report (2006), the smallest numbers of the board in Malaysia is three directors and the biggest is fifteen directors with an average nine directors in a board.

(d) Independent Director

Independent directors describe as a directors does not hold any executive position in the company (MCCG, 2001). The MCCG (2001) recommends that at least one-third of the board should consist of independent directors.

(e) CEO Duality

CEO duality is a separation of CEO and chairman post in the firm. A separation the position is recommend by MCCG (2001) to ensure a balance of power and authority.

(f) Institutional Investors

Institutional investors refers to the top five institutional shareholdings in each firm. The institutions are the Employees Provident Fund (EPF), the Lembaga Tabung Angkatan Tentera (LTAT), the Lembaga Tabung Haji (LTH), the Permodalan Nasional Berhad (PNB), and the Social Security Organisation of Malaysia (SOCSO).

1.7 Significance of the Study

Results from this study hopefully will be able to explain the relationship between corporate governance and cost of equity that will be beneficial not only to the investors but also to the firm itself. The impact of corporate governance to the cost of equity are very important to the firms' and also to the investor because they will get better information about how well their company or their investment. The level of investor confidence will depend on market demand size organisations by using information

available in public to make an estimate cost of equity. By using Malaysia as a study, this study will be able to see whether there is a relationship that exists between corporate governance and cost of equity because the environment and culture in Malaysia is different from the environment and culture in other developed countries, because firms in Malaysia, mostly owned by the family (Thillainathan, 1999, and Graham *et al.*, 2002). This ownership structure is assumed to reduce the cost of equity, but this does not mean there is no agency cost problem because there is still a conflict of interest between shareholders .

The internal corporate governance variables in which are used in this study are “the size of the Board, the level of independent director, and CEO-duality structure”. This study also reviews the external variables of corporate governance as institutional investors in connection with the cost of equity. Previous research finds that poor corporate governance tends to reduce the level of investor confidence (Noordin, 1999). These researchers also find that poor corporate governance leads to errors in reporting the financial progress (Agrawal and Chadha, 2005).

1.8 Organisation of the Remaining Chapters

This study is divided to seven chapters. The first chapter gives an introduction as well as an overview of this study. The second chapter presents the institutional background covering the development of the capital market and corporate governance in Malaysia. The third chapter presents the review of literature that covers points from previous studies in lieu to corporate governance and cost of equity. The fourth chapter presents the conceptual framework and the hypotheses development.

Chapter five illustrates the data and variable in terms of research design, sample collection, measurement of variables, and the method of data analysis. Chapter six analyzes the results of finding, focusing on statistical analysis, descriptive statistic, correlation analysis and multivariate analysis. Lastly, chapter seven presents the summary of findings and insinuations of the research are discussed, limitation of the study as well as suggestion for future research and concludes this thesis.

CHAPTER 2

INSTITUTIONAL BACKGROUND

2.1 Introduction

This chapter presents an overview of the Malaysian institutional background. Section 2.2 begins with the background of Malaysian Capital Market development, and section 2.3 covers on Corporate Governance in Malaysia, and in section 2.4 there will be discussion on institutional investor in Malaysia. Finally, Section 2.5 will conclude the end of this chapter.

2.2 Malaysian Capital Market

The capital market refers to the market for medium and long term financial assets. The capital market includes corporate stock, the government bond market, the market for private debt securities, public and private debt securities with maturities exceeding one year, and shares with no fixed maturity traded in the stock market. The capital market is also known as conducting market debt and equity securities transactions, in which public companies and the government to increase their long-term funds.

Since the late 1980s, the capital market in Malaysia has experienced rapid development. In 1989, listing of companies from Malaysia and Singapore stock exchanges is an important milestone in the development of the Malaysian equity market. In 1993, with the proliferation of privatization projects and equity of growth, it has given one of the fastest growing markets in the region of Malaysia. In addition, to enable many companies

to obtain cheaper financing, equity markets have contributed to the development of the private sector, with an initial public offering (IPO) and the issuance of new shares. Consequently, the development of equity investment by individual investors, institutions, and tourism increase markedly, and market infrastructure has been developed accordingly. Regulators, the Kuala Lumpur Stock Exchange (KLSE) and Securities Commission (SC), have increased the standards on transparency, disclosure, accounting, and corporate governance. In 2004, the Kuala Lumpur Stock Exchange (KLSE) changes its name to Bursa Malaysia.

Securities Commission Act 1993 has established the Securities Commission (SC) on March 1, 1993. Securities Commission Malaysia (SC) is responsible for regulation and development of capital market in Malaysia. The main role of the SC is to act as a regulatory body to promote capital market development which is responsible for streamlining the securities market regulations, to speed up the processing and approval of corporate transactions, to regulate all matters relating to unit trust schemes, and to regulate the taking translation, and mergers of companies.¹

Beginning of the 1997/98 Asian financial crisis has affected the activities of the offshore fund-raising by Malaysian companies. Malaysia has a large impact on the performance of economic growth and capital markets as a result of this crisis. As a result of critical actions by governments and financial regulators, health, economic and capital market have not fully recovered. The impact of the Asian financial crisis has not changed, and foreign participation in Malaysia's capital market is not fully met. The impact of the crisis

¹ The SC is responsible to the Minister of Finance and tables its annual report and account to Parliament. It is empowered to investigate breaches of securities regulation, enforce rules and regulation, and prosecute securities offences. The Capital Issues Committee (CIC) and Panel on Take-Overs and Merges (TOP) were dissolved their functions absorbed by the SC. A number of functions pertaining to the capital markets previously undertaken by other authorities were also transferred to the SC gradually over the ensuing years.

posted participants and international investors in the Malaysian capital market to be affected.

The banking sector is affected the most because of more loan proceeds, coupled with the lack of prudential regulation and supervision. Capital markets, particularly equity markets, have an indirect role in increasing the number of bank loans. Banks actively raise funds in the equity market, which expands their capital base. With the development of capital markets and capital account liberalization, disintermediation combine to some extent. However, in the mid-1990s and the role of the offshore bond market is insignificant, except for bonds with warrants issued during the equity boom.

Beginning in 1992, the corporate entity has been active in fund tapped the equity market, doing IPOs and new share issues to finance the current simple equity boom at that time. For some corporate players, the funds raised from capital markets and banks are to optimize and grow their financial assets. Even if the explosion took place, they successfully build their corporate empires. Unfortunately they have to settle large debts from the banking sector and the bond market when it is over. The impact of this bankruptcy, non-performing loans (NPLs) of certain banks have been established. In addition, stock brokers try to take advantage by providing their customers with credit facilities for share trading. However, in July 1997, the share price plunges amid the financial crisis and this causes the banking and brokerage stocks to suffer losses as a result of a breach of consumer loans, in particular. This is due to capital stock broker that is not sufficient to deal with huge losses. As a result, several stock brokers to be in trouble and suspended by the KLSE or now known as Bursa Malaysia. In addition, a

slow increase in the capital markets has reduced the momentum of capital market activities.

Responding to the impact of financial crisis, the Securities Commission introduces the Capital Market Masterplan (CMP) to determine the direction of the Malaysian capital market for the next ten years which commenced from 2001 to 2010. At first it is announced on August 6, 1999 by Second Finance Minister and Chairman of the Securities Commission. After that, it is approved by the Minister of Finance in December 2000 before it is launched in February 2001. CMP goals are developed to set the framework for long-term development market and provide clarity for issuers, investors, and intermediaries.

The CMP provides a strategic roadmap for the development of capital markets and the efficient mobilization and allocation of funds with high confidence for market participants to outline the vision by the CMP. In 2001 and 2010, the CMP contains 152 recommendations are related to the development of the capital market regulation. With this 152 recommendations it is covering 11 areas of the equity market, bond market, derivatives market, the stock broking industry, market institutions, investment management, regulatory framework, corporate governance, capital market, technology and e-commerce as well as training and education. However, beginning June 2011, according to The Report Malaysia 2011 (as cited by Oxford Business Group, 2011), the capital market is transformed with the announcement that Bursa Malaysia will move into the FTSE Advanced Emerging Markets Indices.

Corporate governance is the tactical central part of the CMP as the Commission considers that good corporate governance among public companies listed are important to achieve the goal of promoting a more favourable setting for investors in the Malaysian capital market. There are ten suggestions to address issues of corporate governance that focus on just management of all shareholders and security of shareholder privileges, and exposé, including transparency minority rights, board independence, regulatory enforcement, corporate ownership, and training and education. Therefore, one suggestion proposed by the CMP is the mandatory disclosure on the compliance with the Malaysian Code on Corporate Governance issued in the revamped listing requirements of the exchange on January 22, 2001 to listed companies.

Other initiatives related to corporate governance involves the conversion of the Kuala Lumpur Stock Exchange (KLSE, now known as Bursa Malaysia) from a jointly owned company to a shareholder-owned company, the introduction of the Corporate Governance Code, and changes in composition and duty Board of Directors. Disclosure rules are also strengthened in 2004.

2.3 Corporate Governance in Malaysia

Discussion on Corporate Governance of Malaysia and other East Asian countries starts from the events of East Asian economic collapsed in the second half of 1997. The phase places a greater concern and recognition of Corporate Governance to the public and private sector in these countries. When foreign investors lose their confidence in Thailand and begin to attract resources caused by devaluation of the financial crisis broke out properly powered. This problem also causes the nation to switch to other

neighbouring countries. The countries that are most affected include Indonesia, Malaysia, South Korea and the Philippines. In Malaysia, there are efforts in trying to prevent further devaluation, but they lead to a higher level of interest rates and credit contraction. The move has resulted in more severe contraction in production and corporate profits are reflected in a massive decline in equity. Zulkafli *et al.* (2005), describes the Kuala Lumpur Composite Index declines by 72% during the period from end-June 1997 to the end of August 1998. Due to the high interest rates and the real estate market crisis, the environment deteriorated markedly. Bank of bodies have been adversely affected because most of their loan exposure in the construction and property sectors and stock financing the purchase. The 1997/98 Asian financial crisis has shown that the lack of corporate governance practices in Malaysia has contributed to the failure of the company (Abdul Wahab *et al.*, 2007). Moreover, Abdul Wahab *et al.* (2007) find that good corporate governance will result in higher firm performance by using the government indexes.

There are different views on the reasons including the economic slowdown, falling property and stock markets that cause the financial crisis. However, there are reasons more fundamental – the national policy of directed lending, less competition and lack of prudential regulations. There are other views to show significant effects of exposure of banking institutions on too much debt to cover the economic boom in the early 1990s as the source of the crisis. According to the International Monetary Fund (IMF) (1999), the crisis affects the domestic policy weaknesses. This is shown by the large current account deficit; focus of bank loans in real estate development and financing the purchase of shares; weakness in the domestic financial system; poor governance and risk management, and too much international borrowing in the corporate sector.

As shown by the provisions of the Companies Act 1965 of corporate governance has been established in Malaysia for a long time, since 1963. It also adds to the Companies Regulations 1966 and the Securities Industry Act 1983. The main source of the reform agenda on Corporate Governance in Malaysia is the Malaysian Code on Corporate Governance by the Finance Committee. They relate to Corporate Governance, Capital Market Master plan (CMP) by the Securities Commission and the Financial Sector Master plan (FSMP) by Bank Negara Malaysia in the financial sector. It offers guidelines on the principles and best practices in corporate governance and direction for the execution and maps the future viewpoints of corporate governance in Malaysia.

In March 2000, the Malaysian Government has set up a committee called the renewal of the Malaysian Code on Corporate Governance (MCCG). The basic principles of the report focus on key areas such as the board of directors, remuneration of directors, shareholders and accountability and audit. MCCG is equal to the Combined Code on Corporate Governance in the United Kingdom. This initiative starts with the Finance Committee on Corporate Governance in 1998 which consists of both government and industry.

Abdul Wahab *et al.* (2008) highlighted the main objective is to promote MCCG corporate disclosure by providing investors with accurate and relevant information so that better investment decisions can be made. This also can serve as a guide to the board of directors of companies to clarify their responsibilities and provide prescriptions to strengthen their control. However, Bursa Malaysia plays a major role in reinforcing efforts to improve corporate governance practices by implementing the code to the Listing Requirements. Through transparency and disclosure requirements, MCCG and

Bursa Malaysia have set up their expectations of accountability (Abdul Wahab *et al.*, 2011) and (Mohd Ghazali and Weetman, 2006). Under this approach, companies in Malaysia have to apply the general principles of good corporate governance code and flexible state of the mind to the different individual companies.

In 2007, MCCG has been revised to improve the Code to strengthen corporate governance practices in line with the development of capital markets. The review of the effectiveness of the audit committees of public listed companies in which the executive director will not be allowed to become members of the audit committee.

2.4 Institutional Investor

Corporate governance also focuses on the rights of minority shareholders. Given the Malaysian companies are generally characterized by a dominant shareholder who controls the protection of minority shareholders right has become more critical. In February 1999, the High Level Finance Committee on Corporate Governance Report Finance Ministry proposed to set the Group Minority Shareholder Watchdog Group (MSWG) to monitor and protect the rights of the minority shareholders.

There are five public and institutional investors and the largest member of the MSWG is established in 2001. The institutions are the Employees Provident Fund (EPF) and the Lembaga Tabung Angkatan Tentera (LTAT) which both are pension funds, Lembaga Tabung Haji (LTH), an investment fund [Permodalan Nasional Berhad (PNB)], and an insurance company [Social Security Organisation of Malaysia (SOCISO)]. Their shareholdings represent approximately 70 percent of total institutional shareholdings in

firms listed on the Main Board of Bursa Malaysia (Abdul Wahab *et al.*, 2008). Among the key roles of MSWG is it acts as a platform to launch collective shareholder activism that is not ethical, monitors the compliance violations in corporate governance practices, and provides training, education and awareness to promote the benefits of shareholder activism and the practice of good corporate governance.

EPF and PNB play an important role in improving corporate governance, which has become an increasingly important issue in Malaysia. PNB is established to increase the Bumiputera shareholding up to 30 percent by 1990. It has a substantial interest in listed companies in various sectors of banking, services, manufacturing, trade, transportation, construction, conglomerates, mining and farming.

EPF and other institutions related to government investment have also been moving their funds to achieve the national target. They are expected to increase Bumiputera's shareholding to 30 percent. Because of this, a small dividend and capital gains through the sale of the shares is not expected, given the passive investment policy. However, PNB and other public investment entities such as the EPF have invested aggressively in equities. Despite the relatively low return on investment (ROI), institutional investors are not coming under fire from the public and part of the reason is the book value / cost accounting system. However, the objective of increasing Bumiputera shareholding to 30 per cent does not encourage them to sell shares in the market. Therefore, institutional investors can implement their rights to raise one or both of the dividend and the value of assets invested in companies with improving corporate governance.

2.5 Summary

This chapter highlights the development of Malaysian Capital Market where the discussion shows public companies and government raised their long-term funds in market transaction securities for debt and equity that are also known as capital market. This chapter also relates the economic crisis in 1997 that necessitate for the corporate governance efforts on the private sector in the country. The corporate governance in Malaysia has been touched to show the impact and effect of corporate governance in Malaysia. The introduction of Malaysian Code on Corporate Governance (MCCG) also is discussed in this chapter. The main idea of MCCG is to encourage and guide boards of directors to strengthen their control. At the end of this chapter, the knowledge about the institutional investor in Malaysia has also been discussed. All of the institutional investor discussed in the last section is a member of Minority Shareholders Watchdog Group (MSWG).

CHAPTER 3

LITERATURE REVIEW

3.1 Introduction

This chapter will present the previous literature on this topic research. Section 3.2 will discuss on agency theory, section 3.3 reviews the literature on corporate governance while section 3.4 discusses prior research on cost of equity. The summary of this chapter will be presented towards the end of this chapter in Section 3.5.

3.2 Agency Theory

In general and current public corporations, there is a notice that the fund providers do not have much control over the spending money in their firm that they invested in and have limited influence on the firm's decision-making process. Owners also hand over the control to the manager or a professional regulatory authority authorized control over firm resources. Therefore, it creates separation of ownership and control leads to a conflict of interest between managers and owners (Berle and Means, 1932). When the manager is engaged in activities that are inconsistent with the firm's goal of maximizing shareholder wealth, it is a clash of interest between the surfaces. This conflict will ultimately reduce the value of the firm. In conclusion, agency theory is commonly viewed as the initial point and base for any discussion and research on corporate governance.

Jensen and Meckling (1976) formally develop the agency costs of outside equity by using the theory of modern corporate agency. This is due to the need to establish corporate governance for the purpose of reducing agency costs arising from opportunistic behaviour of management. They also define the agency relationship as a contract where one party (the principal) engages another party (agent) to perform some services on behalf of the mother. The principal will delegate some decision-making authority to the agent when they manage the firm on their behalf. In the framework of public listed companies, the directors are the agents of shareholders, while the shareholders act as the principles. Shareholders delegate power to the directors to oversee the management of the firm.

According to the agency theory, corporate governance problems or dilemma occur from the split ownership and control in corporate organisations. Other than that, it also arises from the failure of widespread shareholders and idle debt holders to control the activities and behaviour of corporate managers properly and efficiently. Jensen and Meckling (1976) have interpreted that agents tend to be self-interested, or have their own agenda other than to pursue the interests of shareholders and foreign investors. The agents have large controls on the functioning of the firm, allotment of resources on behalf of shareholders and the controlling information disclosed to the suppliers of capital. Self-interested intentions encourage managers to switch the assets to activities that affect the firm's objective of maximizing shareholders' wealth.