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Corporate Governance Compliance's Effect on Malaysia's Capital Structure

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Abstract
This research looks at how well publicly traded firms in Malaysia adhere to the corporate governance code of best practices and how it relates to their capital structure. From 1998 to 2006, a sample of 126 corporations' annual reports and Thompson DataStream were analyzed to get the data. Multiple regression analysis is used in the research to examine aspects of the board of directors, including dual leadership, board size, and board meetings. The majority of the business has cooperated successfully with the code, according to the study's preliminary findings, and there is a strong correlation with the firm's capital structure.

Keywords: Board of Directors Features, Capital Structure, Dual Leadership, and Corporate Governance

Introduction

Following the Asian crisis in the middle of 1997, the Malaysian Institute of Corporate Governance (henceforth, MICG) implemented a Code of Best Practices for publicly traded corporations in 2001. The Board of Directors, one of the key components of corporate governance, offers extra benefits to the company's shareholders and other investors since it acts as an efficient monitoring system to lessen agency conflict. By giving the Board of Directors additional authority and participation in the company's decision-making, it enforces stricter oversight by shareholders. The adoption of the Code of Best Practices by businesses must be justified prudently to the extent that corporate governance is not legally mandatory. Corporate governance is described as follows in the High Level Finance Committee Report on Corporate Governance (1999, p. 10). This definition suggests that investors in businesses that use best practices would be able to reap greater returns on their investment. Recent research on the connection between corporate compliance and performance (Bai et al., 2003; Bauer et al., 2005; Black et al., 2005; Chiang, 2005; Drobetz et al., 2003; Gugler et al., 2003; Nandelstandh & Rosenberg, 2003; Wan & Ong, 2005; Noriza et al., 2007, and Noriza (2008). Put another way, non-complying companies' stock returns would be negatively impacted by the market penalizing them for choices that prevent them from realizing more value. However, the fact that there are significant differences in corporate compliance across businesses in the same nation (Mohamad Ishak et al., 2004; Klapper and Love, 2004) indicates that some businesses are not yet persuaded of the benefits of implementing corporate governance. This research will ascertain whether or not companies with greater levels of corporate compliance perform noticeably better than those non-complying organizations in an effort to discover evidence that may persuade these non-complying enterprises. In keeping with the ultimate goal of corporate governance, which is to achieve "long-term shareholder value," this research measures the company's capital structure using debt to equity (D/E), debt ratio (DR), and interest coverage (IC).

This research focuses on the Board of Directors (BOD) since it is one of the most significant corporate governance instruments, if not the only one. Bursa Malaysia mandates that publicly traded companies adhere to and publish certain BOD-related information in their annual reports, such as the size, makeup, and dual leadership of the board.

The fact that all directors must complete a Mandatory Accreditation Program (MAP), which is followed by an annual Continuing Education Program (CEP), for example, demonstrates the legislators' conviction that the BOD is a successful corporate governance tool. Directors are the company's main overseers because they are the elected representatives of the firm's shareholders. They keep an eye on management to make sure that its decisions are always (Note 2) trying to maximize corporate value in the long run for the shareholders and (Note 3) ready to be accountable for its actions to all stakeholders, especially the shareholders (Corporate Governance Committee, 1997).

Companies, particularly those in developing capital markets, are always under pressure to enhance their corporate governance architecture in order to effectively compete with their rivals for external capital in the global stock market as economies become more interconnected.

This is how the rest of the research is organized. The literature on corporate governance compliance and the capital structure of firms is reviewed in Section 2. The data and technique are explained in Section 3. The results and discussion are presented in Section 4, and the company's suggestions are concluded in Section 5.

Overview of Literature

Definition of Corporate Governance

The Malaysian Institute of Corporate Governance (henceforth, MICG) introduced a Code of Best Practices for publicly listed companies in 2001 in response to the Asian crisis in mid-1997. As an effective monitoring mechanism to reduce agency conflict, the Board of Directors, one of the essential elements of corporate governance, provides additional advantages to the company's shareholders and other investors. Stricter scrutiny by shareholders is enforced by granting the Board of Directors more power and involvement in the company's decision-making. Businesses must carefully justify their adoption of the Code of Best Practices to the extent that corporate governance is not required by law. The High Level Finance Committee Report on Corporate Governance (1999, p. 10) provides the following description of corporate governance. According to this concept, investors would be able to get higher returns on their investment in companies that follow best practices. Current studies on the relationship between performance and corporate compliance (Bai et al., 2003; Bauer et al., 2005; Black et al., 2005; Chiang, 2005; Drobetz et al., 2003; Gugler et al., 2003; Nandelstandh & Rosenberg, 2003; Wan & Ong, 2005; Noriza et al., 2007, and Noriza (2008). In other words, the market punishing noncompliant corporations for decisions that hinder them from generating more value would have a negative effect on their stock returns. Nonetheless, the fact that corporate compliance varies significantly across companies in the same country suggests that some companies are not yet convinced of the advantages of putting corporate governance into practice (Mohamad Ishak et al., 2004; Klapper and Love, 2004). In an attempt to provide data that could convince these non-complying businesses, this study will determine whether or not corporations with higher levels of corporate compliance perform notably better than those non-complying organizations. In line with the ultimate objective of corporate governance, which is to attain "long-term shareholder value," this study uses debt to equity (D/E), debt ratio (DR), and interest coverage (IC) to gage the capital structure of the business.

Since the Board of Directors (BOD) is one of the most important, if not the only, corporate governance tools, this study focuses on it. Publicly listed firms are required by Bursa Malaysia to comply with and disclose certain BOD-related information in their annual reports, including the size, composition, and dual leadership of the board.

For instance, the lawmakers' belief that the BOD is an effective corporate governance instrument is shown by the requirement that all directors undergo a Mandatory Accreditation Program (MAP), which is followed by an annual Continuing Education Program (CEP). As the chosen representatives of the company's shareholders, directors serve as the primary overseers. They monitor management to ensure that it is constantly (Note 2) attempting to maximize business value for the shareholders in the long term and (Note 3) prepared to answer for its actions to all stakeholders, particularly the shareholders (business Governance Committee, 1997).

As economies grow increasingly linked, companies, especially those in emerging capital markets, are always under pressure to improve their corporate governance architecture in order to successfully compete with their competitors for external capital on the global stock market.

The remainder of the study is structured in this manner. Section 2 reviews the literature on capital structure and corporate governance compliance. Section 3 provides an explanation of the data and methodology. Section 4 presents the findings and discussion, and Section 5 concludes with the company's recommendations.

Corporate Governance Compliance and Firm’s Capital Structure

In 2002, Mohamad Ibrahim et al. (2004) conducted a study on the annual reports of 556 publicly traded businesses in Bursa Malaysia, previously known as the Kuala Lumpur Stock Exchange. They discovered that these companies had a very high level of corporate compliance with the Code of Best Practice. Additionally, corporate compliance is consistently high for all BOD-related corporate governance mechanisms or practices, such as: (i) BOD composition; (ii) BOD responsibilities, such as the separation of powers between the Chairman and the CEO; (iii) BOD meetings; (iv) board committees; (v) director compensation; and (iv) BOD training. Their results align with the Governance (GOV) index score proposed by Klapper & Love (2004). Malaysia ranks sixth in the Index, after South Africa (66.53), Singapore (65.34), Chile (61.63), Hong Kong (58.27), and Brazil (57.26), behind 13 other rising nations. When the scope is narrowed down to the Pacific Basin nations, the findings indicate that Malaysia has done well in

comparison to the other nations in the area since they also reveal that Malaysia is ranked third, after Singapore and Hong Kong. This is in addition to the fact that other nations have more developed economies than Malaysia. As noted by Pass, C. (2006), the updated Combined Code included additional clauses about the membership of the Board of Directors and its principal Committees, as well as the status and responsibilities of the chief executive and chairman. With a focus on non-executives being "independent" in accordance with the Code's standards, these new regulations were particularly concerned with giving a company's non-executive directors more authority in top-level decision-making. The new Code mandates that businesses abide by its regulations and, if feasible, take the necessary steps to ensure compliance or provide an explanation for noncompliance. Therefore, the Code upholds the UK custom of "voluntary" compliance rather than

compared to law enforcement. Any "enforcement" is up to the shareholders, who may reject an explanation at the AGM if they don't agree with it.

While corporate governance and business performance have been the subject of several studies, capital structure has received less attention. Theoretically, a company's capital structure funding is determined by the board of directors. BOD makes a wise financing choice for the business in accordance with the corporate governance code of best practices. In his study on how corporate governance affects capital structure, Abor J. (2007) found that there is a significantly negative relationship between board size and capital structure and an opposite finding regarding the relationship between CEO duality and leverage, which suggests that larger boards adopt low debt policies and that the CEO, as the chairman of the board, tends to employ a high proportion of debt. Similar research on the connection between corporate governance and capital structure was conducted by Pfeffer & Salancick (1978), Lipton & Lorsch (1992), Berger et al. (1997), and Wen et al. (2002). The results showed that corporate governance has an impact on businesses' capital structure decisions. Contrary to Jensen (1986), there is a high debt ratio or leverage due to bigger boards.

Large shareholder ownership, state ownership, and the percentage of independent directors are all adversely correlated with the likelihood of distress, according to a research by Zong-Jun (2006) that used a sample of 96 financially troubled enterprises and 96 healthy companies. A company's financial situation is also severely harmed by managing agency expenses. However, the likelihood of default is not much impacted by the level of management ownership, board size, CEO duality, or balanced ownership. Additionally, they divide the sample into state-controlled and non-state-controlled businesses in order to examine the impact of state-controlling rights. The findings show that corporate-governance characteristics had distinct effects on the two subsamples' financial distress status.

There is conflicting information about the final impact of corporate governance compliance on a company's high debt levels. For example, a study conducted on small and medium-sized businesses (SMEs) by Abor J. & Biekpe N. (2008) found positive correlations between capital structure and CEO duality, board composition, and board competence. The results suggest that SMEs adopt lower debt policies with bigger boards. Another important finding that should be emphasized is that SMEs that have a larger proportion of highly qualified board members, outside directors, and a one-tier board structure tend to use more debt. Although the association is not statistically significant, Fama & Jensen (1983) discovered that CEO duality also affects the firm's financing choice. In a different research on corporate governance and capital structure choices made by Chinese listed companies, Wen.Y., Rwegasira, K., & Bilderbeek, J. (2002) discovered that managers often want less financial leverage when confronted with better corporate governance from the board. Their findings, however, only demonstrate the importance of CEO tenure and board composition; board size and fixed CEO salary have negligible impacts.

Research Methodology

Operational Definition of Facets of BOD based on Malaysian Code on Corporate Governance (MCCG) and Capital Structure

Dual Leadership (DL), Board Size (BS) and Board meeting (BM)

In the MCCG, it was stated that under DL, there should be a clearly accepted division of responsibilities at the head of company, which will ensure a balance of power and authority, such that no one individual has unfettered powers of division. Where the roles are combined there should be a strong independent element on the board. A decision to combine the roles of chairman and CEO should be publicly explained in the companies' annual report. In this study, it was indicated 1 for the combined position of CEO and chairman and 2 for separated. In terms of BS, every board should examine its size, with a view to determining the impact of the number upon its effectiveness. MCCG also stated that the board should meet regularly, with due notice of issues to be discussed and should record its conclusions in discharging its duties and responsibilities. Data on board size was collected based on the ranking; 1 if number of BOD is less than 5 persons, 2 for 6-10 of BOD, 3 for 11-15 of BOD, 4 for more than 15 BOD and 5 if the company do not disclose the information in the annual report. The board should disclose the number of BM held a year and the details of attendance of each individual director in respect of meetings held.

From such disclosure, the study was developed a ranking as same as applied to board size for the board meeting.

Capital Structure

In finance, capital structure refers to the way a corporation finances its assets through some combination of equity, debt, or hybrid securities. In this study, capital structure refers to debt ratio, debt to equity and interest coverage.

Determinants of variables

There are two main variables in this study, dependent and explanatory, and the proxies that represent the dependent variables are (i) Debt Ratio (DR), (ii) Debt to Equity (D/E) and (iii) Interest Coverage (IC) and explanatory variables are (i) Dual Leadership, (ii) Board Size and (iii) Board Meeting.

To examine the firm's capital structure, this study used the following equations;

DRi TLi TA

D / Ei TDi TE

ICi EBITi InterestExpenses

Where TLi = Total liabilities of the ith company for each year,

TAi TEi TDi

= Total assets of the ith company for each year,

= Total shareholder's equity of the ith company for each year,

= Total Debt of the ith company for each year, and

EBITi = Earnings before interest and taxes of the ith company for each year.

InterestExpensesi = Interest Expenses of the ith company for each year.

Next, the relationship between the BOD facets and firms' capital structure will be estimated using the following regression equations:

Where = the constant term,

DRi   1(DL1)   2 (BS2)   3 (BM3)   i (1)

D / Ei   1(DL1)   2 (BS2)   3(BM 3)   i (2)

ICi   1(DL1)   2 (BS2)   3(BM 3)   i (3)

 = the slope or coefficient estimates of the explanatory variables,

DLi = the BOD hold two position of the ith company,

BSi = the BOD size of the ith company,

BMi = the BOD meeting of the ith company,

i = the standard error of the ith company,

DRi = the debt ratio of the ith company,

D / Ei = the debt to equity of the ith company, and

ICi = the interest coverage of the ith company.

Sampling and Data Collection

The sample of 126 companies had been randomly selected consist of four industries; (i) consumer products, (ii) industrial products, (iii) trading/services, and (iv) plantations of public-listed companies in the Main Board of the Bursa Malaysia for a nine conservative years period from 1998 to 2006. Financial institutions are excluded because they are governed by special rules. The data before that period constitutes the pre-implementation of corporate governance (pre-ICG) cover year 1998 to 2000, the data between the first implementation and the aforementioned period constitutes the mid-corporate governance period (mid-ICG) cover year 2001 to 2003 and the following data on 2004 to 2006 constitutes the post- implementation of corporate governance (post-ICG). For the purpose of collecting information on the BOD, this study will use the companies' annual reports. Annual reports are sufficient for gathering such data considering listed companies must abide to Securities Exchange Commission's requirement of such disclosure. Thompson's DataStream was used to employ the data on firm's capital structure.

Hypothesis

The null hypothesis of the study is developed to cater for the pooling regression model. The null hypothesis is: H0: There is no relationship between capital structure and BOD facets.

H1: There is a relationship between capital structure and BOD facets.

Discussion on Empirical Results

Analysis of Corporate Governance Compliance among BOD Facets during Pre, Mid and Post Implementation of Corporate Governance Code of Best Practices in Malaysia

According to Malaysia Code on Corporate Governance (2000), it was stated that if one person hold dual leadership (as a chairman and CEO), they should disclose all the responsibilities and descriptive job between the chairman and the CEO. It is also visibly stated that there should be a clearly accepted division of responsibilities at the head of the company, which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision. Where the roles are combined there should be a strong independent element on the board. A decision to combine the roles of Chairman and Chief Executive should be publicly explained. As we can see from figure 1 (see appendix), most companies in Malaysia did not combine the role of chairman and CEO of the board of director. It been prove by the result of this study that show more than 70% of overall companies for the pre-ICG and more than 80% for the mid-ICG and post-ICG has two different person that hold the position of chairman and CEO. Only a few of companies apply RD that results are only 10.6% (pre-ICG), 6.9% (mid-ICG) and 12.4% (post-ICG). Hence, before the code of practice is introduced, the board of director already separates the role between the two. According to research done by Shamsul Nahar

Abdullah (2004), the role of the board is likely to be minimal as one person is controlling both the operations (as a CEO) and the internal monitoring (as a board chairman). Thus, the leadership and control responsibilities lie in the hands of one individual.

Again, according to MCCG (2000), it was stated that every board should examine its size, with a view to determining the impact of the number upon its effectiveness. See appendix for figure 2, most of the companies assign 6 to 10 board of directors to lead the companies during mid-ICG and post-ICG with 56.3 percent and 79.5 percent respectively. Only

1.9 percent, 3.7 percent and 1.3 percent of the companies that assign more than 16 persons of the board size during pre, mid and post respectively. As for the study period, a total of 31.9 percent of the companies didn't disclose their number of directors. Some point of view saying that corporate performance will be better if there is a larger board because they have a range of expertise to help make better decision. However, Jensen (1986) and Lipton & Lorsch (1992) argue that large boards are less effective and are easier for the CEO to control. When a board gets too big, it becomes difficult to co-ordinate and process problems. Smaller boards also reduce the possibility of free riding by, and increase the accountability of, individual directors.

The corporate governance practices suggested that the board of director should meet regularly, with due notice of issues to be discussed and should record its conclusion in discharging it duties and responsibilities. The practice also suggested that details of attendance of the directors are revealed in annual report during the financial year to make sure the directors are committed to be part of the company. In the study, it was found that majority of the companies complied very well with the practice after the corporate governance was implemented compared to before the code was introduced. As shown in figure 3 (see appendix), for the pre-ICG indicated that 43.7 percent of the companies are not concern to disclose their number of board meeting in their annual report. However, after this code of conduct been introduced, we can see the trend is changing. Most of the companies starting to complied with the code for the mid-ICG (96.8 percent) and post-ICG (98.9 percent). Most of the company was conducted a meeting with in a range of 6 to 10 times a year, for mid-ICG (61.9 percent) and post-ICG (71.1 percent).

Analysis of the Relationship between BOD Facets with the Firm's Capital Structure

Table 1 (see appendix) shows the result for the multiple regressions for all variables involved in the study. From the result we can see from panel A for the pre-ICG, there are only DE have a relationship with the BOD facets such as DL (-2.069) and BS (2.556) at 5 percent significant level. Therefore, we do not accept the null hypothesis of H0 and accept H1 at this level. For the Mid-CG in panel B, where the corporate governance code being introduced, there is a relationship between DL and IC at the p value of 0.05 and t-ratio of -1.976. Another BOD facet that has a relationship is between BS and DE at the p value of 0.05 and t-ratio of 2.136. We can accept H1 and do not accept H0 because it shows that there is a relationship between variables. As some authors suggested, the effects of these two factors on firm performance can be both positive and negative (Finkelstein, D'Aveni 1994), which helps to explain why this study found no significant effect of the two factors on firm performance. As for Post-CG in panel C, it shows that the entire three BOD facets have a relationship with the capital structure of the companies such as DL with DR (2.148) and DE (3.106) at 5 percent and 1 percent respectively. IC also has an association with BS (5.045) and BM (-2.219) at 1 percent and 5 percent respectively. Therefore, we can accept H1 and do not accept H0 at this level. As pointed out by Keun Lee (2002) that reviewed the post-crisis reform of corporate governance system in Korea from the point of view of the conditions for efficient governance, the Korean system can be said to have been improving although several issues still remains to be settled.

The results in the table 2 (see appendix) shows that the standard deviation for the DR during pre-ICG (panel A) and post-ICG (panel C) indicate the highest 746.91 and 313.99 while the lowest is for DE are 40.78 and 68.59 respectively. However, for mid-ICG (panel B) indicates difference result where the highest is IC (2908.28) and the lowest is DE (36.73). In terms of correlations, the significance level at 5 percent for the pre-ICG only on BS with IC at 0.118 and BS with DL at 0.105. For mid-ICG, the correlation existed between DE and DR at 1 percent (0.256) and BS and DE at 5 percent (0.105). The improvement of significant level for post-ICG where RD are correlated with DR at 5 percent (0.106) and DL with IC (0.160) and BS with IC (0.247) at 1 percent respectively.

Conclusion and Recommendation

The bulk of the firms listed on Bursa Malaysia have shown excellent compliance with the code of corporate governance principles, according to this survey. The numbers in section four demonstrate that the firms have revealed the number of board meetings held in their annual reports, particularly during and after the mid-ICG. Furthermore, it was discovered that the majority of the organizations had six to ten directors, which is in line with Lipton & Lorcsh's (1992) proposal that the ideal board size is eight or nine, with ten being the maximum for a board to be effective. This research demonstrated the high level of compliance with the

MCCG regarding dual leadership, whereby a decision to merge the responsibilities of chairman and CEO should be publicly explained in their annual report. Additionally, this analysis discovered evidence that suggests corporate governance and the firm's capital structure are related, as well as data that suggests the factors are unrelated. There is no connection between the firm's DR and IC and BOD aspects for the pre-ICG. Additionally, it was discovered that there is a link between the variables (for mid-ICG and post-ICG), even if it is not a strong association since the R value is less than 60%, which is in line with the recommendation of Gompers et al. (2003).

According to the study's recommendations, a lot of corporations continue to fail to declare the number of directors and board meetings in their annual reports, which should be in compliance with the MCCG. The study also believes that a larger sample size should be employed in future studies. Finally, businesses that did not adhere to the corporate governance code need to emulate those that did. This is due to the fact that the research discovered a connection between the capital structure of the organization and corporate governance. Businesses that have sound governance practices will draw in investors. Because they have enough money and resources, these businesses may then compete in the industry in which they operate. It is strongly advised that businesses adhere to the code since doing so would boost investor trust.

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