CORPORATE GOVERNANCE MECHANISMS AND SHAREHOLDER EXPROPRIATION OF THE MALAYSIAN LISTED CONSTRUCTION COMPANIES

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Abstract

The construction industry plays an important role in the Malaysian economy development. However, there are reports that have disclosed the main predicament confronting this industry – a prevailing weak corporate internal control. As a result, the interests of shareholder are not protected by the management but expropriated. The main objective of this research therefore is to examine the relationship between the corporate governance (CG) elements and shareholder expropriation in Malaysian construction listed companies. As a longitudinal study of 37 public listed construction companies in the Main Board of the Bursa Malaysia over the period 2007 to 2011, this study discusses the influence of the CG elements: CEO duality, shareholder activism by institutional, independent director with tertiary education, corporate diversification, and family-ownership structure on monitoring the shareholder expropriation. The control variables such as firm size, firm age, and profit leverage are included in the model to reduce the likely effects that can invalidate the results. Firm performance as the proxy of shareholder expropriation is measured by using the Net Profit Margin and Dividend Payout Ratio. Using Ordinary Least Square and Fixed Effects Model analysis methodology, the findings suggested that there is linear relationship between family-ownership structure and shareholder expropriation. However, the Pearson correlation analysis has suggested that the correlation of family-ownership structure to shareholder expropriation is weak. As a conclusion, the findings in this study contradict the predictions of the theories and concepts examined here except for the family ownership structure. Therefore, it is recommended that the period of study could be extended and also to include other related industries such as the property sector. In addition, a longer period of study will probably show the likely influences of changes in the CG system of a company, with different results.

APPROVAL PAGE

I certify that I have supervised /read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in quality and scope, as a thesis for the fulfilment of the requirements for the degree of Doctor of Philosophy.

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Declaration

I hereby declare that the thesis submitted in fulfilment of the PhD degree is my own work and that all contributions from any other persons or sources are properly and duly cited. I further declare that the material has not been submitted either in whole or in part, for a degree at this or any other university. In making this declaration, I understand and acknowledge any breaches in this declaration constitute academic misconduct, which may result in my expulsion from the programme and/or exclusion from the award of the degree.

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GLOSSARY OF KEY ABBREVIATIONS

ACGA	Asian Corporate Governance Association
ACGS	Asean Corporate Governance Scorecard
ADB	Asian Development Bank
AGM	Annual General Meeting
APO	Asian Productivity Organization
BL	Bursa Listing (synonyms: Bursa Malaysia Berhad)
Blueprint	Corporate Governance Blueprint (Malaysia)
BMSB	Bursa Malaysia Securities Berhad
BNM	Bank Negara Malaysia
CA	Companies Acts 1965
CCM	Companies Commission Malaysia
CEO	Chief Executive Officer
CG	Corporate Governance
CIDB	Construction Industry Development Board
CMP	Capital Market Master Plan
CMP2	*Capital Market Masterplan 2* (CMP2)
Committee	Malaysia, High Level Finance Committee
DPR	Dividend Payout Ratio
EGM	Extraordinary General Meeting
EPF	Employees Provident Fund of Malaysia
FSMP	Financial Sector Master Plan
GDP	Gross Domestic Product
IMF	International Monetary Fund
INEDs	Independent Non-executive Directors

IPO	Initial Public Offering
KLCI	Kuala Lumpur Composite Index
KPMG	Klynveld Peat Marwick Goerdeler
MAICSA	Malaysian Institute of Chartered Secretaries and Administrators
MASB	Malaysian Accounting Standards Board
MCCG	Malaysian Code on Corporate Governance
MCGI	Malaysian Corporate Governance Index
MIA	Malaysian Institute of Accountants
MNC	Multinational Corporation
MPT	Modern Portfolio Theory
MSWG	Minority Shareholder Watchdog Group
NEP	New Economic Policy
NGO	Nongovernmental Organization
NPM	Net Profit Margin
OECD	Organization for Economic Co-operation and Development
PLCs	Public Listed companies
PwC	PricewaterhouseCoopers
ROA	Return on Assets
ROB	Registrar of Businesses
ROC	Registrar of Companies
ROE	Return on Equity
ROSC	Report on the Observance of Standards and Codes
SC	Securities Commission Malaysia
SSM	Suruhanjaya Syarikat Malaysia

CHAPTER 1

INTRODUCTION

The focus of this study is on the relationship between corporate governance and shareholder expropriation in general, and in the construction industry in particular. Invariably, therefore, an enunciation of both of these terms is necessary to set the appropriate tempo for further discussion. At the macro level – in terms of the economic well-being of a nation or country, corporate governance according to Sir Adrian Cadbury in “Global Corporate Governance Forum” (The World Bank, 2000), is about maintaining “the balance between economic and social goals and between individual and communal goals”. Its framework is “to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources, “with the aim “to align as nearly as possible the interests of individuals, corporations and society”.

However, at the micro level – in terms of corporate businesses, corporate governance is about “the system by which business corporations are directed and controlled”. In this regard, the OECD (April 1999) has asserted that “the corporate governance structure specifies the distribution rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, “thus defining the rules and procedures for corporate decision-making. Furthermore, in compliance with the latter, the OECD has pointed out that “it also provides the structure through which the company objectives are set and the means of attaining these objectives and monitoring performance”.

And *WhatIs.com* has provided yet another dimension on corporate governance which advocates "the rules, processes, or laws by which businesses are operated, regulated, and controlled". The latter therefore suggests that corporate governance involves balancing the interests of numerous stakeholders in a company including its shareholders, management, customers, suppliers, financiers, government, and the community. This definition underlines what the American corporate governance doctrine primarily describes as the control rights and related responsibilities of three main groups: (1) the shareholders of the company or firm who provide capital and must approve major firm transactions; (2) the Board of Directors of the company or firm who are elected by the shareholders to oversee the management of the corporation; and (3) the senior executives of the company or firm who are responsible for the day-to-day operations of the corporation.

Understandably, there is indeed a relationship between corporate governance and shareholder expropriation, the latter also known as "tunneling". According to Wikipedia, tunneling is a "colloquial for financial fraud committed by (the) company's own management or major shareholders, consisting of legally pumping out valuable property into their own, private firms". It cautions, however, that such fraud should be differentiated from theft which is illegal, and proceeded to explain the "legality" in accordance with two principles adopted by Court assessment of tunneling as follows: (1) "Duty of Care" that holds the Director responsible "to act as a reasonable, prudent or rational person would act in his (or her) position; and (2) "Duty of Loyalty" or "fiduciary duty" that "addresses conflict of interest (whereby) insiders must not profit at the expense of outsider shareholders or the corporation". The research findings of Stijn Claessens and Burcin Yurtoglu, in "Corporate

Governance and Development – An Update" (A Global Corporate Governance Forum Publication, with International Finance Corporation, 2012) have reiterated the importance of "legal and other reforms" because "(they) can provide benefits, since they are necessary foundations for an effective corporate governance system". Such reforms range "from mandatory internal and external controls to competent, adequately staffed regulators to securities laws that strongly protect shareholders from dilutive offers, freeze-outs, and fraud".

The construction industry is one of the key sectors that have been contributing to the Malaysian GDP achievement over the years. However, there have been reported scandals, incidents of corruption, and also fraudulent practices are not without its share of good and adverse publicity, and abandoned projects, implicitly suggesting that there are problems and issues that need resolution and clearer legislative enforcement that can improve the efficacy of the industry as a whole. Corporate governance is a timely watchdog and good governance practices can contribute to further positive values and economic growth.

The objective of this research is to examine the relationship between various corporate governance attributes and the shareholder expropriation in Malaysia construction industry. Studies have documented that there is an association between the corporate governance system and the value of the firm, and vice versa. Investigation on corporate governance in the Malaysia construction industry is sparse, hence the need to identify the critical corporate governance elements for this study and their relationships that investors might have overlooked in the past.

1.1 Background of the Study

Despite legislation and reform measures on corporate governance and the voluntary corporate governance codes, there are researchers who argue that the overall effects of corporate governance on a firm's value and performance remain unclear (Black, Jang and Kim, 2006). Undoubtedly, corporate governance effectiveness is still at an infancy stage especially in the areas of transparency and board independence. However, there are studies that have shown that legislative reforms have increased corporate values in countries such as Malaysia and Hong Kong (Miles, 2003).

Why do countries consider corporate governance seriously? According to Doidge, Karolyi and Stulz (2007), this is because there is an intimate bond between a firm's cost and good governance. However, lack of mechanisms, either due to unavailability or prohibitive costs, countries with investor protection or poor economic and financial development cannot implement corporate governance properly and consistently. The authors further asserted that good governance enables firms to access capital markets on better terms, which is valuable for firms intending to raise funds. Even though the corporate governance level varies widely across countries and across firms, the investors normally would expect firms to plan well to access the capital markets, especially for firms with growth opportunities that cannot be financed internally.

Generally, good governance does help to sustain and grow a firm's value. From the perspective of a nation's economic development, the contribution of good governance should not be under-estimated. Researchers have provided numerous evidences that improvements in quality corporate governance on Gross Domestic Product (GDP) growth, productivity growth, and the ratio of investment to GDP is indeed positive, significant, and quantitatively relevant. The growth effect is particularly pronounced for industries that are most dependent on external finance (De Nicolo, Laeven and Ueda, 2008).

According to Philip Koh (2007), prior to the financial crisis in 1997, Malaysia had already put in place a relatively high standard of corporate governance based on a strong common law system along with a corporate law regime inherited from the British pre-independence rule. The Asian financial crisis basically exposed the weak corporate governance practices in Malaysia: weak corporate financial structures; over-leveraging; poor disclosure and accountability; a complex system of family control; and above all, unenforceable or no effective laws to protect small investors; assets shifting; conglomerate structures that were perceived to be given preferential treatment; allegations of cronyism; lack of transparency and unclear regulatory processes. Nevertheless, the writer had disclosed that the key failing for the 1997 financial crisis was due to the equivocalness over the autonomy of regulators, jurisdictional boundaries and insufficient transparency of the regulators.

Indeed, Malaysians involved actively in the corporate governance reforms after the 1997 Asian financial crisis that witnessed the share market plunge unprecedentedly and the capital market regime increasingly vulnerable, have egged the Malaysian government to develop a comprehensive framework for good practices of corporate governance. Sarji (2007) had highlighted that the remedial measures implemented have provided a catalyst for the improvement and enhancement of