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Corporate Governance, Transparency and Performance of Malaysian Companies

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Transparency and Performance of Malaysian Companies

Che Haat, Mohd. H., R. Rahman, and S. Mahenthiran

Abstract

The paper aims to examine the effect of good corporate governance practices on corporate transparency and performance of Malaysian listed companies.

I

Introduction

The Asian financial crisis that started in 1997, partly originated from the prolonged recession in Japan in the early 1990s (Sachs, 1998), which adversely affected the performance of many East Asian economies, including Malaysia. It is generally believed that a lack of sound corporate governance was to a certain extent, a major reason for this economic crisis in the East Asian region (Mohammed *et al.*, 2006; D'Cruz, 1999; Khas, 2002). Also, the downfall of worldwide corporate giants such as Enron, Xerox, Worldcom and Parmalat (to name a few) have left deep scars on the corporate world in general. It has been shown that most corporate failures including Enron and Worldcom, can be caused by the lack of good corporate governance. The US accounting scandals hastened the understanding of the wide-ranging effect poor corporate governance can have on a country's economy, through the effects on the capital markets. Such incidents have adversely affected public confidence in the reliability of corporate reporting. In Malaysia, the scandals in the USA, as well as the 1997-1998 financial crises, have been considered as a wake-up call to the need for better corporate governance and transparency among Malaysian companies. The Malaysian corporate landscape has been blemished by a couple of cases of bad corporate governance such as Renong, Perwaja Steel and Malaysia Airlines System (MAS).

Poor corporate governance, weak investor relations, a low level of transparency in disclosing information by companies listed on the Bursa Malaysia (BMB) or formerly known as the Kuala Lumpur Stock Exchange (KLSE), and the ineffectiveness of regulatory agencies in enforcing legislation in punishing offenders and protecting minority shareholders, are all partly blamed as reasons attributing to the collapse of several Malaysian companies (Mohamad, 2002). These problems have drawn attention to the need to maintain corporate governance standards, increase transparency and improve investor relations, while the market regulatory agencies such as the Securities Commission (SC) and BMB should press for more effective enforcement of legislation. A survey of the investment community and financial intermediaries in Malaysia, conducted by *The Edge* and Bulletin International, a UK-based public relations and image management consultant, revealed clear evidence of such problems. The respondents indicated that increasing transparency, improved corporate governance and better investor relations helped to increase capital inflow into the country (*The Edge*, 8 June 1998).

According to Graham *et al.* (2002), the cost of poor corporate governance is borne heavily by minority shareholders, which is the case in emerging markets like Malaysia where many public companies are family owned. One of the ways to improve investor confidence is to have good governance practices that may contribute to better financial disclosures and more transparent business reporting. According to Frost *et al.* (2002), improvements in corporate governance practices that contribute to better disclosures in business reporting in-turn can facilitate greater market liquidity and capital formation in emerging markets. As such, corporate governance is of critical importance to investors, insurers, regulators, creditors, customers, employees and other stakeholders. However, several questions need to be answered: are Malaysian companies concerned about corporate governance and transparency? Is good corporate governance a prerequisite to good business and market performance?

Lee (2003) cites a finding disclosed by KPMG and *The Edge* (a leading weekly business report published in Malaysia) where only 75 companies among more than 800 companies listed on BMB (which is less than 10 per cent as of 31 December 2002) provided a positive economic return, therefore creating value to the shareholders, while the rest instead destroyed value. This is supported by Chen *et al.* (2004), who are of the opinion that in emerging markets, majority shareholders who are closely associated

with corporate insiders act as if minority investors capital has no opportunity cost. Hence, they do not feel obliged to provide a return to the shareholders.

Recognising the importance of corporate governance and disclosure adequacy, it is vital to have a study focusing on developing a framework and benchmarking corporate governance practices among Malaysian companies. Hence, this study attempts to find out whether good corporate governance practices have a positive relationship with the timeliness of reporting, level of disclosure as well as company's performance. The findings of this study are important to regulators, investors, academics and others who contend that good corporate governance is important for increasing investor confidence and market liquidity (Donaldson, 2003). With the regulations focusing on corporate governance introduced by the Malaysian authorities (as part of their corporate governance reform agenda), such as the Report of Finance Committee on Corporate Governance, the Malaysian Code of Corporate Governance and Bursa Malaysia Listing Requirements, there is a widely held view that better corporate governance is associated with better firm performance. However, the evidence is tenuous (LeBlanc and Gillies, 2003).

The results of our study of 73 good performance companies and 73 bad performance companies found that corporate governance factors have a strong predicting power on company performance, mainly due to debt monitoring and foreign ownership. However, there is a significant negative relation between audit quality and performance. The results find that performance is not associated with the level of disclosure and timely reporting. The results indicate that disclosure and timeliness are not significant contributing factors in the relationship between corporate governance and market performance.

The remainder of this paper is structured as follows. In the next section, we review the literature on internal governance, ownership structure and financing factors as well as audit quality. The following section provides a discussion on hypothesis development which involves the relationship between corporate governance and performance, as well as between corporate governance and transparency. The third section explains the methodology used to satisfy the objectives of study. The fourth section reports the results of the study, leading to a conclusion, implications and limitations of the study.

Literature review

Internal governance

The board of directors is an important component of internal governance that enables the solving of agency problems inherent in managing any organisations. The board has the power to hire, fire and compensate the top-level decision managers and to ratify and monitor vital decisions. Board of directors are widely recognised as an important mechanism for monitoring the performance of managers and protecting shareholders' interests (Fama and Jensen, 1983). The Malaysian Code on Corporate Governance (MCCG) (Finance Committee on Corporate Governance, 2001) also recognises that good corporate governance rests firmly with the entire board of directors and as such, they should take the lead role in establishing best practice.

With regard to the independence of board of directors, it is argued by both agency theory and resource dependence theory (Fama and Jensen, 1983; Pearce and Zahra, 1992) that the larger the number of non-executive directors (NEDs) on the board, the

better they can fulfil their role in monitoring and controlling the actions of the executive directors (ED), as well as providing a window to the outside world. The premise of agency theory is that NEDs are needed on the boards to monitor and control the actions of ED due to their opportunistic behaviour (Jensen and Meckling, 1976). Mangel and Singh (1993) opine that NEDs have more opportunity for control and face a complex web of incentives, stemming directly from their responsibilities as directors and augmented by their equity position. Hence, NEDs are considered as the check and balance mechanism in enhancing the board's effectiveness. In addition, those who share a similar opinion include Fama and Jensen (1983) who argue that outside directors might be considered to be "decision experts"; Weisbach (1988) notes that NEDs should be independent and not intimidated by the CEO; able to reduce managerial consumption of perquisites (Brickley and James, 1987) and they can act as a positive influence over directors' deliberations and decisions (Pearce and Zahra, 1992).

Empirical evidence on the association between outside independent directors and firm performance is mixed. Studies have found that having more outside independent directors on the board improves performance (Daily and Dalton, 1994), while other studies have not found a link between independent NEDs and improved firm performance (Hermalin and Weisbach, 1991). The point that can be made from these studies is that there is no clear benefit to firm performance provided by independent NEDs. Petra (2005) argues that the mixed results may be reflective of a corporate culture wherein corporate boards are controlled by management and the presence of independent NEDs has no discernable impact on management decisions.

However, other empirical evidence does suggest that independent NEDs do play the important role of being a shareholder advocate. For example, studies have shown that shareholders benefit more when independent NEDs have control of the board in tender offers for bidders (Byrd and Hickman, 1992) and in hostile take-over threats (Gibbs, 1993). Furthermore, Beasley (1996) reports that an investigation commissioned by the Treadway Commission into the governance structures of failed firms indicates that the boards of directors were dominated by management and "grey" directors (i.e. outsiders with special ties to the company or management). Beasley (1996) found that independent NEDs reduce the likelihood of financial statement fraud. These studies indicate that independent NEDs do monitor and control management and this could lead to better company performance.

Another aspect of corporate governance that has become a concern nowadays is the "dominant personality" phenomenon (Forker, 1992). The issue revolves around role duality, that is, when the CEO is also the Chairman of the board. There are two views in this issue. Firstly, the proponents of agency theory argue for a separation of the two roles to provide essential check and balances over management's performance (Argenti, 1976; Stiles and Taylor, 1993; Blackburn, 1994). On the other hand, the alternative argument based upon stewardship theory is that the separation of roles is not vital, since many companies are well run with combined roles and have strong boards fully capable of providing adequate checks. In addition, when the role is combined, the CEO may be able to shape the company to achieve stated objectives due to less interference. Those who advocate role duality are Eisenhardt (1989), Dahya *et al.* (1996), Donaldson and Davis (1991) and Rechner and Dalton (1991). The basis of their arguments is stewardship theory, which suggests that managers act in the best

interests of the firms and shareholders, and that role duality enhances the effectiveness of boards.

As for the association between role duality and performance, Abdul Rahman and Haniffa (2003) documented that Malaysian companies with role duality seem not to perform as well as their counterparts with separate board leadership based on accounting performance measurement. Dahya *et al.* (1996) also concluded that the market responds favourably to the separation of the roles and that the accounting performance of firms with role duality appears to decline. In other words, a separation of the role of the Chairman and CEO will help enhance monitoring quality and reduce the advantages gained by withholding information, and therefore the quality and timeliness of reporting will improve. In looking at the Malaysian context, role duality is not particularly common among listed companies although the potential impact on disclosure and timeliness and ultimately the effect on performance is considered worthy of testing (Haniffa and Cooke, 2002).

Another important aspect of corporate governance is about the issue of directors (regardless of executive or non-executive) who may sit on more than one board (cross-directorships). Dahya *et al.* (1996) suggest that cross-directorships will help in making information more transparent as comparisons can be made based on knowledge of other organisations. Hence, decisions made at one board may become part of the information for decisions at other boards. In addition, the interlocking of CEOs is desirable because of their experience and credibility as peers. This has been emphasised by Lorsch and MacIver (1989, p. 27) who assert that "serving on board is a way to see how somebody else is doing the same thing". In other words, CEOs join other boards and thereby create interlocking relationships specifically to "embed" what they are doing (Davis, 1996).

High management ownership where managers obtain effective control of the firm will be negatively related to firm value because of management entrenchment (Shleifer and Vishny, 1989). These authors argue that managers entrench themselves by making manager-specific investments that make it costly for shareholders to replace them. According to Wright (1996), the possible reason is because managers with high levels of stock ownership, the potential for undiversified personal wealth portfolios, and the potential for entrenchment may elicit management decisions inconsistent with a growth-oriented, risk-taking objective of enhancing shareholder value.

Studies investigating the relationship between firm performance and managerial stock ownership have come up with mixed evidence (Demsetz and Lehn, 1985; McConnell and Servaes, 1990; Hermalin and Weisbach, 1991). In the USA, studies show that the effect of insider ownership to company performance is dependent upon the percentage of ownership. For example, Morck *et al.* (1988) find a positive relationship when the ownership is below 5 per cent, but shows a negative relationship when the range of ownership is between 5 and 25 per cent. Hiraki *et al.* (2003) also provide evidence in their study on Japanese firms that insider ownership is positively related to firm value and expropriation of firm resources to the determinant of minority shareholders.

The empirical ambiguity of the relationship is often cited as evidence of a complex role of insider ownership. This is because while it aligns the interests of managers and shareholders and thus enhances performance, it also facilitates managerial entrenchment and adversely affects performance. Himmelberg *et al.* (1999) find no

meaningful correlation between managerial ownership and performance. However, Khanna *et al.* (2005) provide evidence that the relationship is not spurious as argued by Himmelberg *et al.* (1999) and there is strong evidence that insider ownership significantly impacts firm value.

La Porta *et al.* (2000) defines corporate governance as a set of mechanisms through which outside investors protect themselves against expropriation by corporate insiders. The degree of expropriation by insiders depends on the investment opportunities available and the cost of expropriation to the firm. Johnson *et al.* (2000) and Durnev and Kim (2003) suggest that insiders expropriate more when the market is bad, and take less when the market is good. These authors argue that one could address the agency problem between outsiders and corporate insiders by imposing a higher cost on expropriation by using growth opportunities, external financing and concentrated ownership. In short, high insider ownership is normally associated with management entrenchment and expropriation of firm resources.

Ownership structure/financing factors

Shareholders can exercise their influence over the governance of individual corporations both formally, through the proxy system where they can initiate and vote on proposals, and informally, through negotiations with corporate management (Davis and Thompson, 1994). Researchers consider foreign ownership and debt monitoring as part of corporate governance because of the influence that they can exert on company's management.

Foreign ownership is expected to be one of the ways of technologically upgrading firms in developing countries, via direct import of new capital and new technologies (Benfratello and Sembenelli, 2002; Kozlov *et al.*, 2000). Another important contribution of foreign investment in transition as well as developing economies is potential spin-offs of western managerial techniques (Kozlov *et al.*, 2000). In addition, foreign-owned firms increase competition in the market, thus forcing domestic firms to restructure faster. Restructuring can take the form of technological improvements and improvement in corporate governance, and changes in the range and quality of goods produced.

Kozlov *et al.* (2000) indicate that foreign firms were found to be more productive than the domestic ones. A number of studies address the relation between performance and the presence of foreign owners. Makhija and Spiro (2000) examine the share prices of 988 newly privatised Czech firms and find that share prices are positively correlated with foreign ownership. Similarly, Boubakri *et al.* (2003), in a study of 189 sampled firms in 32 developing countries found that profitability and efficiency gains are associated with the presence of foreign owners. This is also supported by Anderson *et al.*'s (1997) study on Czech privatised companies. Similar results are reported by Hingorani *et al.* (1997), who conclude that insider and foreign ownership mitigate agency problems through incentives that align the interests of managers and investors.

In Malaysia, there has been no empirical evidence published with respect to the direct impact of foreign ownership and corporate governance practices. However, it is expected that foreign ownership has an indirect impact on corporate governance, due to the presence of foreign-owned firms that will increase competition in the market, and therefore exerting pressure on local firms into having good corporate governance at least at par with foreign-owned firms. It is hoped that the presence of foreign

ownership as an aspect of governance mechanism would be able to enhance firm performance.

In relation to debt financing, Bushman *et al.*(2004) found that board structure and high ownership are not independent, and that these governance variables are related to earnings timeliness and organizational complexity. Their study shows that limited transparency and complexity of firms' operations are causes of high insider ownership concentration. To overcome the agency costs of high ownership concentration levels, managers and insiders can show their willingness to be monitored by creditors such as banks by increasing their public borrowing (Harvey *et al.*, 2003; Diamond, 1991).

Harvey *et al.* (2003) found that in emerging markets where extreme information asymmetry exists between corporate insiders and outsiders, the company uses debt borrowed in international markets to signal their willingness to be monitored by debt holders. However, following the Asian crisis, Malaysia prohibited currency trading and raising debt in developed markets and thus the opportunity to reduce agency costs between insiders and outsiders by this means is also unavailable. Therefore, domestically issued short-term debt will not discourage corporate insiders from using it to further their own entrenched interests, which will only attenuate the agency problems between insiders and outside equity shareholders.

According to Sarkar and Sarkar (2005), excess cash flows in a firm will give opportunities for self-interested managers to take on projects with negative NPV and such an "overinvestments" problem reduces the market value of the firm and impacts shareholder value adversely. Hence, given the high agency costs of insider ownership and the need for capital, the poor performance companies would rely on a larger amount of debt financing than the rest.

Audit quality

Audit is an important element of efficient equity markets, because audits can enhance the credibility of financial information, directly support better corporate governance practices through transparent financial reporting (Francis *et al.*, 2003; Sloan, 2001) and therefore ultimately influences the allocation of resources (SEC, 2000). Theoretically, a large public accounting firm with greater investment in reputational capital has more reason to minimise audit errors via "auditor-reputation effects" (DeAngelo, 1981; Beatty, 1989). In addition, Dye (1993) argues that large audit firms are inclined to supply a higher quality audit compared to small firms, as more wealth is at stake in large audit firms. They will also experience a greater loss through reputation damage if the quality of their audit does not meet the accepted quality standards.

DeFond and Jiambalvo's study (1993) indicated that large audit firms are more independent of management. They found that the (then) Big Eight audit firms experienced a greater number of disagreements with former clients than non-Big Eight firms. Therefore, empirical evidence seems to support the differential audit quality based on the type of audit firm. There are a number of empirical studies supporting the positive relationship between audit quality and audit firm size (Palmrose, 1988, 1986; Francis and Simon, 1987; Jang-Yong Jonathan and Lin, 1993; Hogan and Jeter, 1997). In addition, as argued by Mitton (2002), that as quality audit is also one aspect of corporate governance, it is expected that firms which are audited by one of Big Four audit firms (a proxy for audit quality) will have a better market performance as well as greater transparency.

Hypotheses development

Corporate governance and performance

Corporate governance mechanisms assure investors in corporations that they will receive adequate returns on their investments (Shleifer and Vishny, 1997). If these mechanisms did not exist or did not function properly, outside investors would not lend to firms or buy their equity securities. Overall, economic performance would likely suffer because many good business opportunities would be missed and temporary financial problems at individual firms would spread quickly to other firms, employees and consumers. Previous evidence suggests that corporate governance has a positive influence over corporate performance. For example, based on industry-level view, Rajan and Zingales (1998) find that firms in industries that require large amounts of external financing grow faster in countries with high scores on their measures of financial development. Thus, corporate governance (measured through better accounting standards, stronger legal protection of investors, and a stronger rule of law) appears to matter for corporate performance. In addition, Liang Li (1999), Williams (2000), Alves and Mendes (2002), Drobetz *et al.* (2003) and Gemmill and Thomas (2004) concluded in their respective studies that there is a positive relationship between good corporate governance practices and firm value.

The above discussion provides a basis to support the argument that there is a positive relationship between good corporate governance practices and firm performance. This is consistent with the agency theory, where better firm performance is achieved due to the fact that good governance practices provide better monitoring and better protection to shareholders. The discussion above leads to the hypothesis:

H1. Other things being equal, stronger internal governance mechanisms lead to significant higher firm performance.

H2. Other things being equal, higher foreign ownership and higher debt financing lead to significant higher firm performance.

H3. Other things being equal, higher audit quality leads to significant higher firm performance.

Corporate governance and transparency

Empirical evidence suggests that improved disclosure has a material impact on the cost of capital. Greater disclosure and timely reporting is said to reduce the cost of equity through lower transaction costs, reduced error in earnings forecasts, or higher demand for a company's securities (Euromoney Institutional Investor, 2001). Another commonly cited benefit of greater corporate disclosure is that, by mitigating information asymmetry, it reduces the magnitude of periodic surprises about a firm's performance and makes its stock price less volatile (Lang and Lundholm, 1999).

As such, strengthened corporate governance and reporting practices, and the improved credibility of financial information that would result, may not eliminate business failure in totality, but could provide the "red flag" signal to the stakeholders especially to the regulators. Hence, in line with past studies, the level of transparency (through better disclosure and timely reporting) is considered a result of good governance practices which in turn can help to reduce information asymmetry between

outsiders and corporate insiders, and between institutional shareholders and minority shareholders. This leads to the next hypotheses which state:

H4. Other things being equal, stronger internal governance mechanisms lead to significant higher level of corporate transparency.

H5. Other things being equal, higher foreign ownership and higher debt financing lead to significant higher level of corporate transparency.

H6. Other things being equal, higher audit quality leads to significant higher corporate transparency.

Relationship between corporate governance, transparency and performance

Corporate governance may have an influence on the level of disclosure (Haniffa and Cooke, 2002) as well as timeliness of reporting, especially as it is the board of directors that manages information disclosure in annual reports (Gibbins *et al.*, 1990). The quantity of information and especially voluntary items disclosed in the annual reports and the time the information to be released, are influenced by the board of directors. Thus, referring back to agency theory, when the board of directors are independent of the management and observe their responsibility to be accountable and transparent to the shareholders or stakeholders, they will disclose on time all the relevant information, not just the mandatory ones but also the voluntary items.

In view of the importance of the disclosure factor (Haniffa and Cooke, 2002) as well as timely reporting (Oh, 2003) in relation to corporate governance in Malaysia, this study attempts to test whether corporate governance practices can predict the level of transparency (more specifically the level disclosure and timeliness of reporting). Then, in turn, higher level of transparency may be able to positively affect firm performance based on the premise that improved disclosure as well as timely reporting may reduce cost of capital and mitigate information asymmetry as argued by Euromoney Institutional Investor (2001) and Lang and Lundholm (1999).

As for the relation between transparency and performance, with increased voluntary disclosure and more timely reporting (therefore greater transparency) Loh (2002) found that firms may gain numerous benefits, including a better managed company, increased management credibility, more long-term investors, greater analyst following, improved access to capital and lower cost of capital, and the realisation of a company's true underlying value. Hence, based on this argument, it is expected that firms with a higher level of disclosure and greater timeliness in reporting will gain better market performance. This leads to the following hypotheses:

H7a. Strong corporate governance mechanisms lead to increased transparency.

H7b. Increased transparency leads to significant higher firm performance.

Research methodology

Sample selection

The sample covers 868 companies listed on BMB (formerly known as the KLSE) as at 31 December 2002. Seventy-five of these companies met the selection criteria by the

KPMG/*The Edge* ranking of the top 75 listed companies by shareholder value creation (*The Edge*, 18 August 2003). However, only the data of 73 of them were useable since there is incomplete data for two companies. The 73 companies were used as the benchmark for companies with good performance similar to arguments made by Peters and Waterman (1982) and Lee (2003). The emphasis on shareholder value creation in this study is based on the premise that accounting performance measures are not necessarily consistent with shareholder value performance (Peters and Waterman, 1982). Therefore, firms which show good accounting performance do not necessarily create better value for shareholders.

In order to compare like with like, the same number of control companies as those of the respective companies set matched by size (total assets) and sector on one-to-one basis were selected from the remaining listed companies. This is similar to the selection method in Abdul Rahman and Limmack's (2005) study on corporate acquisitions of Malaysian listed companies. In order to select 73 companies that will match the good performance group, the total asset figures (from year 2002 annual reports) for all companies listed on BMB were collected. Then, for each industrial sector, the companies were ranked according to their total asset figures. The most comparable company to the good performance group company is identified according to the nearest total asset figure in each sector. To identify company performance, Tobin's Q is calculated for each firm. To take into account the effect of different industries which the companies belong to, industry-adjusted Q is calculated to represent the relative performance. Out of the total 146 sample firms, four were eliminated as they were considered as outliers, because the Q value of the two of them were extremely high (above 100), while the remainder recorded negative Q. Consequently, the number of usable sample companies was further reduced from 146 to 142.

Data collection

The data collected for this study comprises two categories: dependent and independent variables. The dependent variable is represented by Tobin's Q. However, in other regression analysis, transparency (which consist of two components: timeliness of reporting and corporate governance disclosure) is also regressed as a dependent variable. Independent variables consist of seven corporate governance characteristics, viz. board independence, board leadership or role duality, quality of directors, insider ownership, foreign ownership, debt financing and audit quality. Table I provides the descriptive statistics for the dependent and independent variables selected in this study, as well as their sources of information. Data on total assets, shareholder equity, number of ordinary shares, total debts and total liabilities are obtained from company's annual report. Share price for each company is obtained from the Daily Diary record provided by BMB in its Public Information Centre. Corporate governance variables are obtained from companies' annual reports at the then KLSE for the fiscal year ending 2002. The year 2002 is chosen for the purpose of observing the effect of new Revamped KLSE Listing Requirements on corporate governance which were introduced in 2001. The new listing requirements require all listed companies to include in their annual reports a separate statement on corporate governance.

Table I.
Operationalisation of the independent, dependent and control variables selal:ed and the source of infonnation

Variables	Acronym	Operationalisation	Source of information
Board composition	INED	Proportion of INED to total number directors on the board	Company annual reports for financial year ending 2002
No role duality	DUAL	Dichotomous: 1 with role duality and 0 if no role duality	Company annual reports for financial year ending 2002
Quality of directors	XDIR	The average number of additional directorships of other Malaysian PLCs held by the INED. It is a proxy for director calibre in the external labour market	Company annual reports for financial year ending 2002
Insider ownership	INSIDER	Percentage of shares retained by inside owners (namely shares issued to management and directors)	BMB's online company database, retrieved from www.klse-ris.com.my
Foreign ownership	FOREIGN	Proportion of shares owned by foreign shareholder to Total shares outstanding	Investors digest (June 2003) which shows foreign shareholding as at 31st December 2002
Audit quality	AUDIT	Statutory audit fees divided by amount of sales	Company annual report for financial year ending 2002
Debt to assets	DEBT	This is equal to long term debts divided by total assets. It is a proxy for debt-financing	Company annual report for financial year ending 2002
Timeliness	TIMELNS	Number of calendar days taken by the company to publish its annual report after fiscal year end	BMB's website (www.bursamalaysia.com)
Disclosure	DISC	The corporate governance reporting score	Company annual report for financial year ending 2002
Tobin's *Q*	QRATIO	Market value of ordinary shares plus total book value of long-term debts divided by net worth (total assets less total liabilities)	Company annual report for financial year ending 2002
Company size		Total asset figures are the proxies for company's size	Company annual report for financial year ending 2002

Measurements

In addition to the explanation on the operationalisation given in Table I for each variable, these are the variables that require further explanation:

Economic profit

In this study, similar to Lee (2003), economic profit integrates three aspects of business economics that create shareholder value, namely, net operating profit after tax (NOPAT), invested capital (IC) and cost of capital. The NOPAT figures used were basically earnings before interest, tax and amortization (EBITA), less adjusted taxes. To compute the IC of a company, an average of its financial year 2001 closing book values of total debt and total equity and its financial year 2002 book values of total debt and total equity was used. The cost of capital is calculated based on its specific weighted average cost of capital, which, in turn, is derived using the weight each company has in terms of its market values of debt and equity. According to the publishers of the business newsletter – *The Edge*, to calculate weighted average cost of capital in 2002 the risk free rate used was 3.5 per cent, and the average risk premium

added to obtain the expected market rate of return was around 4.5 per cent. The key measure by which the companies were ranked in this study was economic profit (or residual income), which is EBITA less weighted average cost of capital of IC. Lee (2003) emphasized that "EP/IC" is used because it would remove the distortion caused by the difference in company size and could be used to rank companies based on economic profits.

Audit quality

Even though there are various factors studied that represent audit quality, it seems that the most commonly studied factor related to audit quality is audit firm size. Previous studies document that Big Four (or their precursors) auditors charge higher audit fees, spend more time on audits, and have fewer lawsuits than non-Big Four auditors, implying that Big Four auditors provide higher quality audits than non-Big Four auditors (DeAngelo, 1981; Francis and Simon, 1987; Palmrose, 1988, 1989). Even after controlling audit risk, client size and audit complexity, there is an additional premium based on auditor identity (Wooten, 2003). Based on the arguments that audit fee can also reflect the level of audit quality (as argued by Shapiro, 1983; Ferguson *et al.*, 2005; Venkataraman *et al.*, 2005) and that there is a positive association between audit firm size and audit fee, this study excludes audit firm size from the correlation and regression analysis. Instead, similar to Che Haat *et al.*'s (2005) study on Malaysian PN4 companies[1], the ratio of audit fee to RM100 of sales is used, as the data is continuous and is expected to provide more robust results compared to the dummy variable used for audit firm size.

Disclosure index

The disclosure index reporting model developed in the current research is based upon factors identified in national and international best practice guidelines and other research studies[2]. The model considers objective factors based on publicly disclosed information. Corporate governance factors are generally divided into two main categories: basic corporate governance variables are those items specifically identified by the Code, and quality corporate governance variables are value-added items generally proposed by other best practices worldwide. It is important to note that the ultimate objective of this corporate governance rating exercise is to encourage the firms to uphold the "substance over form" principle of governance rather than merely a "box-ticking" process of compliance with statutory regulation.

In this study, unlike the self-assessment questionnaire designed by the Forum for Corporate Governance in Indonesia (2003), and the voluntary disclosure index by Haniffa and Cooke (2002), and the corporate governance questionnaire used in Saldana's (2000) study (which only provided a dichotomous scale of a "yes" or "no" options), the checklist is designed so that every individual disclosure is evaluated based on a five point of Likert scale. We measured the level of corporate governance reporting based on the extent to which companies disclose the relevant information in their annual reports. The list classifies the contextual factors into eight major groups that simultaneously emphasize the practicability and world-class quality of reporting goals. However, to keep our disclosure index comparable to those used in prior studies, we focused only on the accountability and transparency measures, which include both

voluntary and mandatory disclosure requirements that are accounting related (Appendix).

Timeliness

BMB's latest Revamped Listing Requirements (January 2001), paragraph 9.23, requires listed companies to submit the annual reports within a period not exceeding 6 months from the close of the financial year of the listed issuer. In addition, companies are also required to submit the interim reports, i.e. quarterly report not later than two months after the end of each quarter of the financial year.

For the purpose of this study, the date of the submission of the annual report is the reporting event used. Similar to the operationalisation used by Syed Ahmad and Mohd Zaini (2003), the annual report submission date is selected because of the important role played by the company's report as a valuable communication tool to users of the information, and the fact that the release of the annual reports are important events as required under the Companies Act (1965) and guidelines issued by the security Commission and the KLSE. Thus, timeliness is measured in terms of the time interval (in number of calendar days) between the fiscal year-end and the date of announcement of the annual report submission made to BMB.

Tobin's Q

Tobin's *Q* is used in this study as a proxy for market return. Tobin's *Q* compares the market value of the firm with the replacement cost of the firm's assets. It also implies that the greater the real return on investment, the greater the value of *Q*. The methodology used to calculate Tobin's *Q* is based on Lindenberg and Ross (1981), Lang *et al.* (1989) and Vogt (1994). The firm's market value is measured by the market value of ordinary shares plus the market value of long-term bonds and the book value of preference shares. The market value of the ordinary shares is estimated by multiplying the number of ordinary shares by the share price at the end of the fiscal year, while the debt value of all companies is equal to the total book value of all long-term debt. The market value of debt could not be obtained because all these companies had obtained private loans, for which information was not available. Similar to Weir *et al.* (2002), the denominator was measured as net worth which is total assets less total liabilities. The total assets and liabilities were determined from the annual reports.

Statistical analysis

All the data were analysed using the statistical package for social science (SPSS) version 12.0. Based on the above discussion, independent variables comprise the percentage of independent non-executive directors (INED) on the board, average number of cross-directorship among INED, role duality, insider ownership, foreign ownership, debt-to-asset ratio and audit quality. The level of disclosure and timely reporting are the variables that represent transparency. The dependent variable is also represented by Tobin's *Q* as a measure of market performance. Furthermore, multiple regression models (based on three dependent variables – Tobin's *Q*, Attribute 5 of CG Reporting Score (disclosure) and timeliness) are used to determine which of the hypothesised explanatory variables affect the likelihood of a firm in creating good performance, and whether corporate governance mechanisms affect the level of disclosure and timeliness of reporting.

Results

The data analysis is to test whether corporate governance mechanisms are significant predictors of market performance, and whether the level of transparency is a significant predictor in the relationship between corporate governance variables and market performance. In brief, *H1* to *H3* states that corporate governance mechanisms lead to higher market performance, while *H4* to *H6* state that corporate governance mechanisms lead to higher level of transparency.

Multiple regression was used to test all the hypotheses which are related to corporate governance attributes, disclosure, timeliness and market performance. Several assumptions in regression analysis have been tested to ensure that there is no significant multicollinearity between the independent variables; that the variance of the distribution of the dependent variable is the same for all values of independent variables (homocedasticity); that a linear relationship exists between dependent and independent variables (linearity); that the distribution of values of the dependent variable for each value of the independent variable is normal (normality) and that no errors related to measurement and specification exist. Multicollinearity was tested based on the correlation matrix. According to Pallant (2001), multicollinearity exists when the independent variables are highly correlated ($r = 0.9$ and above). The results of the test indicate that all the correlation coefficients between the independent variables are less than 0.9. An analysis of residuals, plots of the studentised residuals against predicted values is conducted to test for homocedasticity, linearity and normality assumptions. As recommended by Pallant (2001), observations with studentised residuals of more than 3.00 are omitted from the analysis. Furthermore, normality tests based on skewness, kurtosis and Kolmogorov-Smirnov or K-S. Lilliefors were also conducted. Transformation is undertaken for both independent and dependent variables when it does not meet the assumptions of normality. For example, Tobin's *Q*, total assets, average number of cross-directorship held by INED, percentage of foreign ownership are transformed into Log while firm age was transformed into square root. The selection of method of transformation is based on the shape of distribution depicted by histogram, as suggested by Tabachnik and Fidell (1996).

The data were analysed by multiple regression using seven different independent variables (which are grouped into three categories) on 142 companies. The first category is the internal governance factors consisting of four variables namely composition of INED on board, no role duality, quality of directors and insider ownership. The second category is ownership structure/financing factors which comprising of foreign ownership and debt financing. The third category contains the variable of audit quality that represents an external governance mechanism. The initial sample consisted of 146 companies, however, for the purpose of regression analysis, four companies with extreme Tobin's *Q* were omitted from the analysis, thus making up 142. Four separate regression models were run, Tables II-V, panels A, B, C and D, individually summarise the regression results.

Table II (panel A) demonstrates the regression results for the relationship between the corporate governance factors and market performance (measured by Tobin's *Q*). The regression produced an adjusted R^2 of 0.392. The results show that company's economic profit (as published by Lee, 2003) has a significant positive influence over market performance. Three corporate governance variables were found to be

Table n.

Panel A: hierarchical regressions: results of prediction between internal corporate governance mechanisms, ownership/financing factors and audit quality on Tobin's Q

Variables	Model 1	Model 2	Model 3
Constant	0.036 (0.269)	−0.114 (−0.567)	−0.600 (−2.305)
Firm age	−0.014 (−0.832)	−0.013 (−0.751)	0.000 (0.009)
Economic profit	0.314*** (5.814)	0.312*** (5.604)	0.322*** (6,542)
Size	−0.007 (−0.329)	−0.009 (−0.371)	−0.003 (−0.101)
Main effects			
Internal mechanisms			
INED		0.207 (0.739)	0.044 (0.178)
Cross-directorship		0.037 (0.471)	0.008 (0.112)
No role duality		0.032 (0.315)	−0.024 (−0.264)
Insider		0.001 (0.769)	0.001 (0.871)
Ownership/financing			
Foreign			0.027* (1.765)
Debt-to-asset			0.695*** (6.210)
Audit quality			−0.088** (−2.586)
R	0.470	0.481	0.661
Change in R^2	0.221	0.011	0.206
R^2	0.221	0.231	0.437
Adj. R^2	0.203	0.189	0.392
F-statistic change	12.541***	0.444	15.357***
Df	3,134	7, 130	10,127

Notes: 1. log_QRATIO $= \alpha + \beta 1$ sqrt_AGE $+ \beta 2$ EconP $+ \beta 3$ log_ASSET $+ \varepsilon$; 2. log_QRATIO $= \alpha + \beta 1$ sqrt_AGE $+ \beta 2$ EconP $+ \beta 3$ log_ASSET $+ \beta 4$ INED +; $\beta 5$ log_XDIR + B6 ROLEDUAL $+ \beta 7$ INSIDER $+ \varepsilon$; 3. log_QRATIO $= \alpha + \beta 1$ sqrt_AGE $+ \beta 2$ EconP $+ \beta 3$ log_ASSET $+ \beta 4$ INED +; $\beta 5$ log_XDIR + B6 ROLEDUAL $+ \beta 7$ INSIDER $+ \beta 8$ log_FOREIGN $+ \beta 9$ DEBT $+ \beta 10$ AUDIT $+ \varepsilon$; performance is measured by Tobin's Q; $N = 142$; *significant at the 0.10 level; **significant at the 0.05 level; ***significant at the 0.01 level

significant foreign ownership, debt-to-asset and audit quality (significant at 10 per cent, 1 per cent and 5 per cent, respectively). All the internal governance mechanisms in the analysis do not have significant influence on firm performance. In addition, the significant relation between debt-to-asset and performance also indicates that market is more confident with the monitoring by firms' creditors. The significant positive relation between foreign ownership and performance is consistent with theory suggesting that foreign investor ownership is positively associated with good performance companies. The results also support the research that shows that the presence of foreign investors in a firm are associated with higher profitability (Smith *et al.*, 1997; Claessens and Djankov, 1999) as well as greater efficiency resulting from higher managerial talent, access to advanced technology, and entry into more lucrative products and capital markets (D'Souza *et al.*, 2001).

Table II (panel A) also shows that there is significant negative relation between audit fee and firm performance, which means that poor performance firms pay relatively higher audit fees when compared to good performance firms. This suggests that poor performance firms rely on higher audit services to improve their performance. This could be because audit quality is an important factor influencing the business conduct of poorly managed companies which in turn improves their performances. Overall, the significant F-statistic change in Model 3, Table II (panel A) indicates that there is evidence to support *H2* that states higher foreign ownership and

Table m.
Panel B): hierarchical regressions: results of prediction between internal corporate governance mechanisms, ownership/financing factors and audit quality on disclosure

Variables	Model 1	Model 2	Model 3
Constant	41.679*** (19.406)	37.303*** (11.519)	37.130*** (7.770)
Firm age	−0.391 (−1.419)	−0.404 (−1.417)	−0.467 (−1.505)
Economic profit	−0.456 (−0.517)	−0.075 (−0.084)	−0.255 (−0.274)
Size	0.600*** (1.733)	0.755** (2.099)	0.810* (1.737)
Main effects			
Internal mechanisms			
INED		10.166** (2.258)	11.159** (2.409)
Cross-directorship		−1.636 (−1.283)	−1.667 (−1.288)
No role duality		0.216 (0.130)	0.540 (0.318)
Insider		0.007 (0.346)	0.007 (0.346)
Ownership/financing			
Foreign			0.163 (0.570)
Debt-to-asset			−1.928 (−0.930)
Audit quality			−0.002 (−0.003)
R	0.161	0.259	0.275
Change in R^2	0.026	0.041	0.009
R^2	0.026	0.067	0.076
Adj. R^2	0.005	0.019	0.005
F-statistic change	1.281	1.490	0.403
Df	3,139	7,135	10,132

Notes: 1. DISC5 = $\alpha + \beta 1$ sqrt_AGE $+ \beta 2$ EconP $+ \beta 3$ log_ASSET $+ \varepsilon$; 2. DISC5 = $\alpha + \beta 1$ sqrt_AGE $+ \beta 2$ EconP $+ \beta 3$ log_ASSET $+ \beta 4$ INED $+ \beta 5$ log_XDIR +; B6 ROLEDUAL $+ \beta 7$ INSIDER $+ \varepsilon$; 3. DISC5 = $\alpha + \beta 1$ sqrt_AGE $+ \beta 2$ EconP $+ \beta 3$ log_ASSET $+ \beta 4$ INED $+ \beta 5$ log_XDIR +; B6 ROLEDUAL $+ \beta 7$ INSIDER $+ \beta 8$ log_FOREIGN $+ \beta 9$ DEBT $+ \beta 10$ AUDIT $+ \varepsilon$; disclosure level in this regression is measured by the score for Attribute 5 of CG Reporting Score while performance measure used is Tobin's Q; $N = 142$; *significant at the 0.10 level; **significant at the 0.05 level; ***significant at the 0.01 level

higher debt financing lead to significant higher firm performance. However, the results suggests that there is no support for *H1* and *H3*, which state that stronger internal governance mechanisms lead to significant higher firm performance, and higher audit quality leads to significant higher firm performance.

Table III (panel B) depicts the second regression results, which serve to examine the association between corporate governance factors and disclosure. The regression produced an adjusted R^2 of only 0.005. This table shows that all the selected corporate governance factors do not significantly predict the level of disclosure.

Table IV (panel C) shows the third regression results for the relationship between the corporate governance factors and timeliness of reporting. The table shows that the adjusted R^2 is 0.008 and only internal governance mechanisms significantly contribute to higher market performance. The implementation of split roles of Chairman and CEO shows a marginally significant association with timeliness (at 10 per cent level). Looking at the coefficient, the table shows that there is a negative relationship between INED and timeliness. As timeliness is measured by number of days taken for a company to publish its annual report, the negative sign means that companies with split roles take less time to publish their annual reports, therefore, there is a positive association between no role duality and timeliness. However, both Tables III (panel B) and IV

Table IV.
Panel C: hierarchical regressions: results of prediction between internal corporate governance mechanisms,ownership\financing factors and audit quality on timeliness

Variables	Model 1	Model 2	Model 3
Constant	− 3.977 (− 0.072)	− 24.262 (− 0.294)	− 109.384 (− 0.899)
Firm age	4.215 (0.595)	4.112 (0.565)	6.714 (0.850)
Economic profit	22.299 (0.984)	19.794 (0.864)	24.084 (1.016)
Size	− 6.525 (− 0.733)	− 6.356 (− 0.693)	− 0.870 (− 0.073)
Main effects			
Internal mechanisms			
INED		111.215 (0.969)	100.041 (0.848)
Cross-directorship		42.243 (1.299)	39.311 (1.192)
No role duality		− 73.440* (− 1.732)	− 77.463* (− 1.789)
Insider		0.768 (1.523)	0.731 (1.416)
Ownership/financing			
Foreign			− 1.797 (− 0.247)
Debt-to-asset			43.543 (0.825)
Audit quality			− 15.788 (− 0.990)
R	0.102	0.259	0.279
Change in R^2	0.010	0.057	0.011
R^2	0.010	0.067	0.078
Adj. R^2	− 0.011	0.018	0.008
F-statistic change	0.479	2.033*	0.525
Df	3,139	7,135	10,132

Notes: 1. log_TIME $= \alpha + \beta 1$ sqrt_AGE $+ \beta 2$ EconP $+ \beta 3$ log_ASSET $+ \varepsilon$; 2. log_TIME $= \alpha + \beta 1$ sqrt_AGE $+ \beta 2$ EconP $+ \beta 3$ log_ASSET $+ \beta 4$ INED $+ \beta 5$ log_XDIR +; B6 ROLEDUAL $+ \beta 7$ INSIDER $+ \varepsilon$; 3. log_TIME $= \alpha + \beta 1$ sqrt_AGE $+ \beta 2$ EconP $+ \beta 3$ log_ASSET $+ \beta 4$ INED $+ \beta 5$ log_XDIR + B6 ROLEDUAL $+ \beta 7$ INSIDER $+ \beta 8$ log_FOREIGN $+ \beta 9$ DEBT $+ \beta 10$ AUDIT $+ \varepsilon$; performance measure used in this regression is Tobin's Q; $N = 142$; *significant at the 0.10 level; **significant at the 0.05 level; ***significant at the 0.01 level

(panel C) indicate that corporate governance mechanisms do not seem to predict higher level of transparency and therefore, there is no support for *H4*, *H5* and *H6* which, respectively, state that stronger internal governance mechanisms lead to significant higher level of corporate transparency; higher foreign ownership and higher debt financing lead to significant higher level of corporate transparency; and, higher audit quality leads to significant higher corporate transparency.

Furthermore, *H7a* states that when corporate governance mechanisms are strong, transparency is increased, and in turn, the increased transparency could lead to higher performance as stated by *H7b*. Table V (panel D) demonstrates the relations between all the corporate governance factors, disclosure and timeliness regressed against company performance. It was found in the regression for the fourth model that the inclusion of disclosure and timeliness into the regression only contributed marginally to change to R^2. The fourth model also shows that its F-statistic change is not significant which means that the inclusion of disclosure and timeliness does not significantly contribute to better firm performance. This means that there is no support for *H7a* and *H7b* either.

Based on the four regressions, the overall results can be summarised in Figure 1. The diagram in Figure 1 shows that for both disclosure and timeliness variables, corporate governance factors do not predict the level of disclosure and timeliness

Table V.
Panel D: hierarchical regressions: results of prediction between internal corporate governance mechanisms,ownership\financing factors, audit quality,disclosure and timeliness on Tobin's Q

Variables	Model 1	Model 2	Model 3	Model 4
Constant	0.036 (0.269)	−0.114 (−0.567)	−0.600** (−2.305)	−0.714** (−2.274)
Firm age	−0.014 (−0.832)	−0.013 (−0.751)	0.000 (0.009)	0.003 (0.167)
Economic profit	0.314*** (5.814)	0.312*** (5.604)	0.322*** (6,542)	0.329*** (6.639)
Size	−0.007 (−0.329)	−0.009 (−0.371)	−0.003 (−0.101)	−0.006 (−0.229)
Main effects				
Internal mechanisms				
INED		0.207 (0.739)	0.044 (0.178)	0.039 (0.155)
Cross-directorship		0.037 (0.471)	0.008 (0.112)	0.022 (0.313)
No role duality		0.032 (0.315)	−0.024 (−0.264)	−0.042 (−0.465)
Insider		0.001 (0.769)	0.001 (0.871)	0.001 (0.955)
Ownership/financing				
Foreign			0.027* (1.765)	0.027* (1.740)
Debt-to-asset			0.695*** (6.210)	0.708*** (6.293)
Audit quality			−0.088** (−2.586)	−0.091*** (−2.675)
Disclosure				0.003 (0.541)
Timeliness				0.000 (−1.251)
R	0.470	0.481	0.661	0.667
Change in R^2	0.221	0.011	0.206	0.008
R^2	0.221	0.231	0.437	0.445
Adj. R^2	0.203	0.189	0.392	0.391
F-statistic change	12.541***	0.444	15.357***	0.846
Df	3,134	7, 130	10,127	12,125

Notes: 1. log_QRATIO $= \alpha + \beta1$ sqrt_AGE $+\beta2$ EconP $+\beta3$ log_ASSET $+\varepsilon$; 2. log_QRATIO $= \alpha + \beta1$ sqrt_AGE $+\beta2$ EconP $+\beta3$ log_ASSET $+\beta4$ INED $+\beta5$ log_XDIR + B6 ROLEDUAL $+\beta7$ INSIDER $+\varepsilon$ 3; log_QRATIO $= \alpha + \beta1$ sqrt_AGE $+\beta2$ EconP $+\beta3$ log_ASSET $+\beta4$ INED $+\beta5$ log_XDIR + B6 ROLEDUAL $+\beta7$ INSIDER $+\beta8$ log_FOREIGN $+\beta9$ DEBT $+\beta10$ AUDIT $+\varepsilon$; 4. log_QRATIO $= \alpha + \beta1$ sqrt_AGE $+\beta2$ EconP $+\beta3$ log_ASSET $+\beta4$ INED $+\beta5$ log_XDIR + B6 ROLEDUAL $+\beta7$ INSIDER $+\beta8$ log_FOREIGN $+\beta9$ DEBT $+\beta10$ AUDIT $+\beta11$ DISC5 + $\beta12$ log_TIME $+\varepsilon$; $N = 142$; *significant at the 0.10 level; **significant at the 0.05 level; ***significant at the 0.01 level

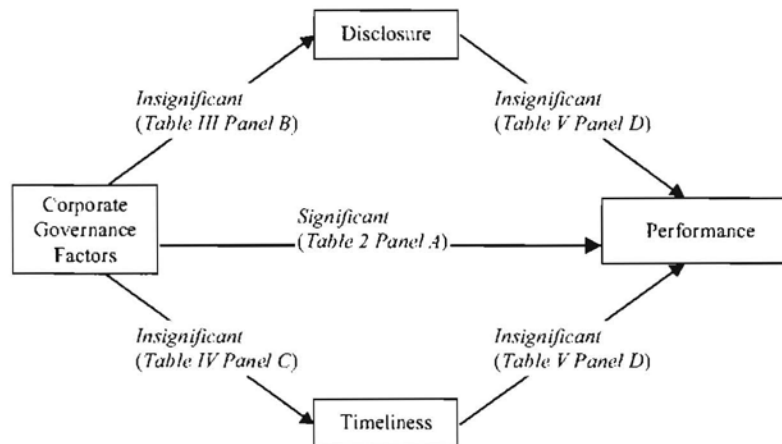

Figure 1.
The sumarized results from four hierarchical regressions

of reporting. Instead, the direct relationship between corporate governance factors and performance is statistically significant.

From this analysis, the overall results indicate that practising good corporate governance is an important factor that influences firm market performance (measured by Tobin's Q). This is shown by the adjusted R^2 of 0.392 in the first regression model, which indicates that 39.2 per cent of the variation in Malaysian listed companies is explained by the independent variables. The two major contributing factors that significantly influence firm market performance are debt financing and foreign ownership. However, there is a significant negative association between audit quality and performance, with poor firms using more audit services than good firms.

Testing the robustness of analysis – split data analysis

In order to test the robustness of the earlier regression analysis, the data is regressed again but at this stage the companies are split into good and poor performance based on the matched pair basis introduced earlier. The results are shown in Tables VI (panel E) up to IX (panel H). Table VI (panel E) Model 2 shows that, consistent with the findings from the earlier regression analysis, the effect of internal governance mechanisms on both the good and poor performance companies is insignificant. This gives an indication that the market does not value internal governance mechanisms implemented within the companies. It might also highlight the way companies respond towards the Code's recommendations, which is possibly more to "box-ticking" rather than taking the "substance" of it. In addition, the negative association of audit quality and performance is stronger to the good performance companies illustrated in Model 3, Table VI (panel E) where the coefficient for audit quality is −0.080 (significant at 10 per cent level) and −0.082, respectively, and 0.570 and 0.756 (both are significant at 1 per cent level), respectively, for debt-to asset. This implies that good do not consider high quality audit service as an important governance mechanism to attain higher performance, although the companies with relatively poorer performance consider external audits (similar to the findings from Ashbaugh and Warfield, 2003; Che Haat *et al.*, 2005) and debt financing as an effective tool to bring back their companies to better performance.

Moreover, when disclosure and timeliness are included in the regression against market performance (Table VII (panel F)), F-statistic change again does not show a significant outcome which means that corporate transparency is not the main concern of the market in assessing firm performance. To examine whether the effect of corporate governance mechanism to disclosure and timeliness is different between the good and poor performance companies, the results in Tables VIII (panel G) and IX (panel H) reveal that there is no evidence showing that corporate governance mechanisms have a significant effect on disclosure and timeliness for both good and poor performance companies. This might indicate that there is also an "expectation gap" between the contents of annual reports presented by Malaysian companies and the way the market uses the information found in the annual reports. Perhaps, annual reports are seen to be less effective in conveying useful information to the users or that the users consider other sources of information about the companies as more reliable and trusted. The other possibility is that investors in Malaysia may not refer to fundamental corporate information as a basis in making their investment decisions, and instead tend to be influenced by speculations in doing so.

Variables	Model 1 Good	Model 1 Poor	Model 2 Good	Model 2 Poor	Model 3 Good	Model 3 Poor
Constant	35.878*** (12.831)	45.888*** (16.955)	27.952*** (6.771)	47.393*** (11.310)	23.914*** (3.639)	51.708*** (8.292)
Firm age	−0.714 (−1.826)	−0.348 (−1.028)	−0.734* (−1.786)	−0.449 (−1.225)	−0.787* (−1.702)	−0.581 (−1.478)
Size	1.580*** (3.247)	−0.070 (−0.175)	1.471*** (2.818)	−0.101 (−0.239)	2.020*** (2.801)	−0.187 (−0.328)
Main effects						
Internal mechanisms						
INED			16.114** (2.404)	4.217 (0.741)	17.340** (2.518)	4.393 (0.748)
Cross-directorship			−2.601 (−1.564)	−0.671 (−0.390)	−2.664 (−1.577)	−0.585 (−0.334)
No role duality			5.035** (2.075)	−3.917* (−1.903)	5.620** (2.287)	−3.592* (−1.677)
Insider			−0.009 (−0.301)	0.008 (0.311)	0.002 (0.062)	0.013 (0.498)
Ownership/financing						
Foreign					0.107 (0.285)	0.034 (0.087)
Debt-to-asset					−4.520 (−1.383)	−1.711 (−0.704)
Audit quality					−0.583 (−0.686)	0.844 (0.983)
R	0.367	0.136	0.488	0.294	0.521	0.325
Change in R^2	0.135	0.018	0.103	0.068	0.034	0.019
R^2	0.135	0.018	0.238	0.086	0.272	0.106
Adj. R^2	0.109	−0.010	0.167	0.002	0.164	−0.024
F-statistic change	5.302	0.646	2.171	1.208	0.938	0.446
Df	2,69	2, 70	6, 65	6, 66	9, 62	9, 63

Notes: $N = 142$; *significant at the 0.10 level; **significant at the 0.05 level; ***significant at the 0.01 level; ***significant at the 0.01 level

Table VI. Panel E: hierarchal regressions: results of prediction between internal corporate government mechanisms, ownership/financing factors, audit quality on Tobin's Q, within both good and poor companies

Variables	Model 1 Good	Model 1 Poor	Model 2 Good	Model 2 Poor	Model 3 Good	Model 3 Poor
Constant	33.598 (0.527)	−54.087 (−0.766)	62.832 (0.647)	−70.433 (−0.616)	−6.936 (−0.045)	−217.608 (−1.363)
Firm age	−1.521 (−1.826)	16.641* (1.894)	2.559 (0.253)	13.372 (1.436)	9.862 (0.868)	20.947** (2.153)
Size	−4.851 (3.247)	−6.835 (−0.663)	−6.850 (−0.568)	−3.482 (−0.327)	−1.302 (−0.077)	12.084 (0.859)
Main effects						
Internal mechanisms						
INED			110.034 (0.699)	111.332 (0.760)	59.379 (0.368)	72.429 (0.489)
Cross-directorship			12.955 (0.331)	34.046 (0.785)	15.587 (0.392)	39.092 (0.912)
No role duality			−96.526* (−1.699)	−89.528 (−1.576)	−102.295* (−1.774)	−125.212** (−2.139)
Insider			0.250 (0.370)	1.186* (1.832)	0.212 (0.298)	0.926 (1.423)
Ownership/financing						
Foreign					−11.547 (−1.318)	−16.753 (−1.579)
Debt-to-asset					51.792 (0.706)	40.928 (0.685)
Audit quality					−13.874 (−0.695)	−34.773 (−1.643)
R	0.074	0.229	0.261	0.386	0.325	0.471
Change in R^2	0.006	0.053	0.063	0.097	0.037	0.072
R^2	0.006	0.053	0.068	0.149	0.106	0.221
Adj. R^2	−0.024	0.023	−0.019	0.066	−0.026	0.101
F-statistic change	0.188	1.806	1.077	1.731	0.848	1.793
Df	2,69	2, 66	6, 65	6, 62	9, 62	9,59

Notes: $N = 142$; *significant at the 0.10 level; **significant at the 0.05 level; ***significant at the 0.01 level

Table VII. Panel F: hierarchical regressions: results of prediction between internal corporate governance mechanisms, ownership/financing factors and audit quality on disclosure, within both good and poor companies

Variables	Model 1 Good	Model 1 Poor	Model 2 Good	Model 2 Poor	Model 3 Good	Model 3 Poor	Model 4 Good	Model 4 Poor
Constant	0.261* (1.661)	0.225 (1.043)	0.298 (1.269)	−0.213 (−0.662)	−0.108 (−0.323)	−0.759* (−1.894)	−0.188 (−0.515)	−0.987 (−1.593)
Firm age	0.023 (1.078)	−0.052** (−2.051)	0.033 (1.383)	−0.070** (−2.529)	0.030 (1.251)	−0.041 (−1.610)	0.032 (1.317)	−0.036 (−1.341)
Size	−0.018 (−0.646)	−0.009 (−0.255)	−0.017 (−0.545)	0.006 (0.228)	−0.011 (−0.306)	0.027 (0.677)	−0.027 (−0.681)	0.029 (0.708)
Main effects								
Internal mechanisms								
INED			−0.387 (−0.995)	0.902** (2.170)	−0.461 (−1.294)	0.637* (1.761)	−0.562 (−1.504)	0.644* (1.735)
Cross-directorship			0.132 (1.369)	−0.009 (−0.069)	0.081 (0.923)	−0.025 (−0.230)	0.117 (1.255)	−0.019 (−0.167)
No role duality			−0.097 (−0.692)	0.031 (0.213)	−0.102 (−0.800)	−0.063 (−0.492)	−0.165 (−1.202)	−0.053 (−0.402)
Insider			0.002 (1.364)	0.001 (0.651)	0.002 (1.387)	0.001 (0.627)	0.002 (1.274)	0.001 (0.680)
Ownership/financing								
Foreign					0.032 (1.629)	0.000 (0.009)	0.029 (1.477)	0.002 (0.083)
Debt-to-asset					0.570*** (3.555)	0.759*** (4.853)	0.601*** (3.696)	0.767*** (4.813)
Audit quality					−0.080* (−1.804)	−0.082 (−1.551)	−0.075* (−1.676)	−0.089 (−1.614)
Disclosure							0.006 (0.890)	0.003 (0.421)
Timeliness							0.000 (−1.001)	0.000 (−0.483)
R	0.131	0.272	0.248	0.386	0.528	0.637	0.546	0.639
Change in R^2	0.017	0.074	0.045	0.075	0.217	0.256	0.020	0.003
R^2	0.017	0.074	0.062	0.149	0.279	0.405	0.299	0.409
Adj. R^2	−0.012	0.045	−0.028	0.064	0.171	0.311	0.166	0.290
F-statistic change	0.587	2.561*	0.748	1.317	6.022***	8.190***	0.817	0.156
Df	2, 68	2, 65	6, 64	6, 61	9, 61	9,58	11, 59	11, 56

Notes: $N = 142$; *significant at the 0.10 level; **significant at the 0.05 level; ***significant at the 0.01 level

Table VIII. Panel G: hierarchical regressions: results of prediction between internal corporate governance mechanisms, ownership/financing factors on the audit quality on timeliness, within good and poor companies

In other words, the results from the split data regression analysis are consistent with the main analysis mentioned earlier. Apart from supporting the results provided by the main analysis, it also reveals further useful results, for example showing that the effect of corporate governance in forms of high audit quality and monitoring by creditors through debt financing are stronger to the poor performance companies as compared to good performance companies.

Discussion

In view of the emphasis by the Malaysian government on good corporate governance practices, the role of this study is to explore the factors that cause poor performance companies to destroy value instead of creating value for their shareholders. In particular, this study investigates how the corporate governance mechanisms including weak disclosures, poor timeliness of reporting and poor debt management may have raised "red flags" to the stakeholders, bringing about intense scrutiny that could help reduce the agency costs to debt holders and equity holders. In order to make a comparison, using a sample of 73 good performance companies based on shareholder value creation (Lee, 2003), and 73 comparable poor performance companies over the year 2002, this study investigates the governance mechanisms, financing strategies, audit quality, disclosures and timeliness which may determine the good from the poor performance companies.

This study attempts to examine the effect of internal governance mechanisms, financing factors/ownership structure and audit quality on disclosure, timeliness and company performance. The estimated equations based on the 142 sample companies strongly indicate that corporate governance matters for the performance of firms in the market, even though the internal governance mechanisms do not have a strong influence on company performance. The results show that debt-to-asset and audit quality have a significant influence over the firm's market performance. This suggests that the external audits serve as an important governance mechanism for creditors, particularly to ensure that poor performance firms with high level of debt practise good debt management which ultimately helps them improve their financial condition. This is similar to the findings made by Mohammed *et al.* (2006). The significant relation of debt-to-asset to performance supports the theory that debt is an important mechanism for solving agency problems in corporations characterised by the separation of ownership and control in Malaysia (Jensen and Meckling, 1976; Jensen, 1986; Stulz, 1990; Hart and Moore, 1995).

However, when the corporate governance variables are regressed against the level of disclosure and timeliness of reporting, the results indicate that corporate governance mechanisms do not influence disclosure and timeliness of reporting. Moreover, when disclosure and timeliness are included in the regression against market performance, the results do not show a significant relationship. This means that transparency is not the main concern of the market in assessing firm performance. Therefore, this study does not provide evidence to show the relationship that corporate governance mechanisms lead to greater corporate transparency and there is also no evidence that transparency contributes to better firm performance.

Conclusion

The possible reason for "ineffectiveness" of other reported internal governance mechanisms in differentiating the performance of companies is due to the effect of the MCCG. The Code was introduced and became effective in 2001, almost one year before the cut off date of the data used in this study. As a result, this study fails to provide evidence that internal governance mechanisms may contribute to better company performance because most companies probably has implemented the recommendations of the Code (as suggested by Eow *et al.*, 2003). Therefore, there is no significant difference between good and poor performance companies insofar as internal governance is concerned. This is contrary to the findings of Leng and Mansor (2005) and Abdul Rahman and Haniffa (2003) who found that internal governance such as role duality has a positive effect on performance. This could also be because of the difference in the measurement used to represent performance in this study. Unlike their studies which use purely accounting performance (ROE as the variable), this study uses economic profit (representing the level of shareholder value creation) suggested by Lee (2003).

In addition, this study introduces variables of disclosure and timeliness in its research framework in order to determine whether market performance is influenced by the level of corporate transparency. Therefore, one of the contributions of this study is to examine whether higher market performance is also due to greater transparency resulting from good governance practice. The insignificant effect of transparency indicates that, in contrary to the theoretical argument by Loh (2002) who suggests that corporate governance may impact transparency and consequently lead to better market performance, this study reveals that transparency is not a significant factor that determines the relationship between corporate governance factors and the market performance of a company.

The findings from this study show that there is no relationship between the level of disclosure and market performance, might lead to the question of disclosure framework in Malaysia. The problem with the framework could be due to investors still being unable to have equal access to disclosed information, or that some investors might have had the information earlier than the others. In addition, the contents of the information disclosed might have not catered to the needs of investors. There might also be certain fundamental information that is lacking in the Malaysian disclosure framework. In their criticisms pertaining to this matter, Standard and Poors (2004) revealed that most of the companies in Malaysia still fell short of global disclosure practice (Standard and Poors, 2004; Toh, 2004), and the current study reinforces their point of view. In other words, there is still inadequate disclosure on corporate governance practices which is mandatory under the Bursa Malaysia Listing Requirements, let alone other voluntary information such as business ethics and responsibility, intellectual capital, reviews of vision, mission and goal statements, as mentioned in this study.

In short, corporate governance does matter to Malaysian listed companies, even though monitoring through internal mechanisms seems to be relatively ineffective. The contribution of this study is that it shows the importance of good corporate governance mechanisms for debt holders and minority shareholders in emerging markets. Stakeholders can play a role in reducing agency cost by monitoring "red flags" of weak corporate governance mechanisms, for example, poor debt management and low audit quality.

Implications of the study

The issue of transparency (in which disclosure and timely reporting are part of) is with regard to the perception of the stakeholders towards the usefulness of annual reports and other sources of information about companies. The findings from this study show that there is no relationship between corporate governance factors and transparency, and there is also no relationship between transparency and company performance. This might indicate that there is an "expectation gap" between the contents of annual reports presented by Malaysian companies and the way the investors use the information found in the annual reports for their investment decisions. Perhaps, annual reports are seen to be less effective in conveying useful information to the users due to the disclosure of information that is no longer relevant to them, or that current users demand more from the contents of annual reports. The other possibility is that it might be due to the users who consider other sources of information about the companies as more reliable, trusted and easily accessible relative to the firm's annual reports. The fact that investors do not rely on annual reports to make financial decisions may worsen the problem of "information asymmetry", since insiders may take advantage of having access to internal information. Thus, it is important for the regulators such as the SC or BMB to educate the investors, so that they will be able to look at the fundamentals of a company rather than solely rely on speculation in making investment decisions.

This study also highlights foreign ownership as one of the most significant predictors to market performance. This indicates that foreign investors have an influential role in affecting the performance of companies particularly because of their better skills in selecting good companies to invest in. When compared to local investors, foreign investors seem to be relatively more critical in making business decisions and tend to look at the fundamentals of a company's governance and performance. Therefore, there is a basis for the Deputy Prime Minister of Malaysia (as quoted in the *New Straits Times* on 26 July 2004) calling local investors to take the lead in investing in the country instead of merely following the foreign institutional funds. The results also support the literature which shows that the presence of foreign investors in a firm are associated with higher profitability (Smith *et al.*, 1997; Claessens and Djankov, 1999), forcing local firms to restructure especially on corporate governance and technology faster (Yudaeva *et al.*, 2000), and higher efficiency resulted from higher managerial talent, access to advanced technology, and entry into more lucrative products and capital markets (D'Souza *et al.*, 2001).

With regard to auditing as a corporate governance mechanism, even though lately there has been news that has put auditors under bad light, for example in the case of Enron in the USA, as well as the AWA and HIH failures in Australia (George and Malane, 2004), this study indicates that quality audit can play an important role as an effective corporate governance mechanism in Malaysian companies. Therefore, the regulators, as well as accounting professional bodies, should take steps to ensure that audit quality is maintained, and that the independence of external auditors is also preserved. This will be reflected in the reliable and credible audit report, which is one of the sources of reference for the users of accounts.

Limitations of the study

The data covers only a one-year period, which is for the year 2002. The purpose of using the 2002 data is in order to observe the effects of the new Revamped KLSE Listing Requirements which were introduced in 2001. The new listing requirements require all listed companies to include in their annual reports a separate statement on corporate governance. Unfortunately, the analysis of corporate disclosure in this study could not be extended beyond the year 2002. This is due to the analysis of annual reports in order to come out with the corporate governance reporting score which was time-consuming, especially in ensuring its reliability and consistency. A researcher has to spend between two to four hours to read and identify the information disclosed in each annual report. The results could have been improved if the data were collected from a period of longer than a year, for example for a four or five-year period.

The findings of this study are only based on the data for 2002. Future studies in this area might want to extend the scope of the data from only a one-year period to a few years, so that one could have a better understanding of the issues of corporate governance especially in an attempt to relate it to certain events, for example the introduction of the MCCG in the year 2001 or the introduction of Best Practices in Corporate Disclosure by BMB in July 2004. Throughout the period of three years between 2003 and 2005, there could be events, especially those associated with the corporate governance reform agenda by the authorities (the SC and BMB), that might have changed the landscape of corporate governance practices. This includes the cessation of Practice Note 4 (PN4) by 31st December 2004 as well as the introduction of new Practice Note 17 (PN17) to replace PN4.

Lastly, this paper deals only with "one-way" causality running from corporate governance mechanisms to performance even though there is evidence of "reverse-way" and "two-way" causality in governance literature. However, given the high insider ownership levels of insiders it is unlikely that the "reverse-way" causality is present in Malaysia.

Notes

1. PN4 is a classification pursuant to the BMB's Listing Requirements, whereby listed companies are required to have an adequate level of financial condition in order to warrant continued trading and listing on the Official List of the Exchange. Starting from 1 January 2005, it was replaced by PN17 which extends the criteria of PN4. In this study, PN4 companies are companies which failed to meet the criteria set out under the BMB's "Practice Note No. 04/2001". They are as follows:
   - The company failed to report the deficit in its combined shareholders funds.
   - Receivers or managers have been appointed to manage the asset of the relevant company/its subsidiaries properties/associate companies.
   - Auditors have given a "disclaimer opinion" regarding the companies outlook in the company's latest accounts.
   - A special manager has been appointed as provided for under the Danaharta Nasional Berhad Management Act 1998.
2. These include OECD White Paper on Corporate Governance in Asia (2003); the IFAC Credibility Report (2003); Standard and Poors (2000); Credit Lyonnais Securities Asia (2001); Blue Ribbon Committee Report of USA (1999); Ernst and Young's Report on Corporate Governance (2002); and the Malaysian Code of Corporate Governance (2000).

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5.0		Level 5	4		Accountability and transparency Level 3	2		Level 1
a.	☐	External auditors, scope and nature of external audit and major findings of external audit investigations are sufficiently disclosed	☐	☐	Notes on external auditors, scope and nature of external audit and major findings of external audit investigations are fairly disclosed	☐	☐	Notes on external auditors, scope and nature of external audit and major findings of external audit investigations are not disclosed
b.	☐	Financial calendars are sufficiently outlined	☐	☐	Notes on financial calendars are fairly outlined	☐	☐	Notes on financial calendars are not outlined
c.	☐	Information on non-audit fees are fully disclosed	☐	☐	Notes on non-audit fees are fairly disclosed	☐	☐	Notes on non-audit fees are not disclosed
d.	☐	Notes on accounting policies and related principles are explained in detail	☐	☐	Notes on accounting policies and principles are generally explained	☐	☐	Notes on accounting policies and principles are not explained
e.	☐	Notes on interim review of the accounting system are sufficiently disclosed	☐	☐	Notes on interim review of the accounting system are only generally disclosed	☐	☐	Notes on interim review of the accounting system are not disclosed
f.	☐	Notes on industry norms, both inter-company and intra-company comparisons are sufficiently reported	☐	☐	Notes on industry norms, both inter-company and intra-company comparisons are fairly reported	☐	☐	Notes on industry norms, both inter-company and intra company comparisons are not reported
g.	☐	The company has sufficiently disclosed its forecast on major financial and non-financial matters	☐	☐☐	The company has fairly disclosed its forecast on major financial and non-financial matters	☐	☐	The company has not disclosed its forecast on any financial and non-financial matters
h.	☐	Sources of pertinent information (for example ratio analysis) are readily available instead of hidden	☐	☐	Sources of pertinent information are not readily available but can be fairly computed	☐	☐	Sources of pertinent information are mostly hidden and not easily computed
i.	☐	Notes on KLSE Listing and other regulatory requirements are sufficiently reported	☐	☐	Notes on Listing and regulatory requirements are generally reported	☐	☐	Notes on Listing and regulatory requirements are not reported

(continued)

Table AL

5.0		Level 5	4		Level 3	2		Level 1
					Accountability and transparency			
j.	☐☐	Notes on appointments of independent professional advisor(s) and service of company secretary are sufficiently disclosed	☐	☐	Notes on appointments of independent professional advisor(s) and service of company secretary are fairly disclosed	☐	☐	Notes on appointments of independent professional advisor(s) and service of company secretary are not disclosed
k.	☐	Notes on segmental reporting is sufficiently included in the financial statements	☐	☐	Notes on segmental reporting is fairly included in the financial statements	☐	☐	Notes on segmental reporting is not included in the financial statements
l.	☐	Notes on penalties and sanctions against or by the company are sufficiently disclosed in the annual report	☐	☐	Notes on penalties and sanctions against or by the company are fairly disclosed in the annual report.	☐	☐	Notes on penalties and sanctions against or by the company are not disclosed in the annual report.
m.	☐	Very clear policy on the engagement of external auditors (is on rotational basis with 5 years maximum)	☐	☐	Fairly clear policy on the engagement of external auditors	☐	☐	There is no policy on the engagement of external auditors
n.	☐	Policy on relationships with external auditors are clearly spelt out	☐	☐	Policy on relationships with external auditors are fairly spelt out	☐	☐	Policy on relationships with external auditors are not spelt out
o.	☐	The annual report sufficiently discloses the company's policy on directors remuneration	☐	☐	The annual report fairly discloses the company's policy on directors remuneration	☐	☐	The annual report does not disclose the company's policy on directors remuneration
p.	☐	The annual report sufficiently discloses the quantum/amount of directors remuneration	☐	☐	The annual report fairly discloses the quantum/amount of directors remuneration	☐	☐	The annual report does not disclose the quantum/amount of directors remuneration
q.	☐	Notes on Board of Directors assessment of company's position are sufficiently disclosed	☐	☐	Notes on Board of Directors assessment of company's position are fairly disclosed	☐	☐	Notes on Board of Directors assessment of company's position are not disclosed

Table AL (continued)