

# Corporate governance literature review samples

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## **LITERATURE REVIEW**

Although the concept of corporate governance has been in practice for several decades, it gained worldwide popularity and significance since the collapse of a number of corporate giants and bank chains in the United States in the early 2000s. The idea of corporate governance is the major factor that links stakeholder interests with the objectives of the organization. As Solms and Solms point out, corporate governance could be defined as “the set of processes, customs, policies, laws, and institutions affecting the way a corporation (or company) is directed, administered or controlled” (Solms & Solms, 2008, p. 2). In the current business context, shareholders, creditors, suppliers, and customers constitute external stakeholders whereas internal stakeholders include the board of directors, executives, and employees. A firm’s corporate governance strategy always strives to enhance the long-term sustainability of the business and thereby to contribute to shareholder values. Identifying the dreadful impacts of accounting fraud and other corporate misbehaviours, today national governments pay greater attention to enforcing well-structured corporate governance laws in the country.

Since shareholders and investors play an inevitable role in keeping the organisation alive by providing necessary finance in times of contingencies, corporate governance policies increasingly focus on promoting investor rights and privileges. In addition, corporate governance laws clearly define the roles and responsibilities of the board of directors, the treatment of employees, and the disclosure requirements. It is important to note that corporate governance policies and practices are different from country to

country. Management experts claim that firms that are in strict compliance with the corporate governance policies are less vulnerable to issues such as accounting fraud or management malpractices. Furthermore, corporate governance policies are vital to eliminate the conflicts surrounding executive compensation, which is a key management issue that modern organisations struggle to combat.

## 2. Corporate governance in Malaysia

Public companies in Malaysia are legally required to comply with the terms and provisions of the Malaysian Code on Corporate Governance 2012. The Malaysian Code on Corporate Governance (Code), first introduced in 2000, is identified to be a major milestone in the history of corporate governance reforms in Malaysia. The Code was later amended in 2007 in order to redefine the 'roles and responsibilities of the board of directors, audit committee, and the internal audit function' (MCCG, 2012). The Malaysian Code on Corporate Governance 2012 (MCCG 2012) promotes the role of directors as active and responsible fiduciaries with intent to strengthen the board structure and composition. According to the MCCG 2012, the directors are considered as the guardians of the company and are expected not only to set the strategic direction and oversee the conduct of the business but also to ensure that the company operates strictly in compliance with the laws and ethical values (Ibid).

Investor confidence in Malaysia significantly declined during the 1997-98 Asian Financial Crisis and the country's policymakers focused increasingly on the need to establish corporate governance standards in an effort to survive the situation. In response to the crisis, the Securities Commission Malaysia

took a series of initiatives including the introduction of Malaysian Code on Corporate Governance in 2000 so as to improve the country's corporate governance framework. Since then, the Securities Commission Malaysia has been on a continuous journey to improve the corporate governance policies and procedures of the country. Today, Malaysian corporations are well informed of the significance of good governance and hence they are committed to developing and sustaining a strong culture of corporate governance. According to the MCCG (2012), corporate governance is defined as " the process and structure used to direct and manage the business and affairs of the company toward enhancing business prosperity and corporate accountability with the ultimate objective of realising long-term shareholder value, whilst taking into account the interest of other stakeholders" (MCCG, 2012).

As part of making corporate governance an integral part of their business culture, Malaysian corporations are required to adopt a set of principles and specific recommendations on processes and structures. The Code 2012 includes a list of eight principles and their corresponding 26 recommendations. Although the observance of the MCCG 2012 is optional for companies, it is the legal responsibility of limited companies to report their adherence to the MCCG 2012 in their annual reports. The Code 2012 gives particular emphasis to promoting the efficacy of the board through improving its composition and independence. The corporate governance framework of the Malaysia greatly encourages companies to respect shareholder rights. As the Securities Commission Malaysia does not suggest a ' one size fits all' approach to corporate governance, companies are free to

choose the best approach to adopting the principles. If the companies fail to comply with a recommendation, they are obliged to explain the reason for non-observance. In short, the current Malaysian corporate governance landscape is very strong so that global investors find Malaysia a potential destination for investment.

### 3. Corporate governance and firm performance

Recent studies suggest that there is a strong link between corporate governance and the performance of trading sector companies in Malaysia. Corporate governance mechanisms can influence managers' choices while they make strategic decisions, which is the key factor determining the firm's operational efficiency and the overall performance (Coles, McWilliams & Sen 2001). In other words, corporate governance policies would force managers to make decisions that are capable of improving the organisational performance consistently in the long-term. In line with this argument, Classens (2006) says that improved corporate governance practices can improve the overall performance of trading sector companies, through more efficient management, asset allocation, labour practices, and other efficiency improvements. It is a clear fact that better corporate governance practices can improve investor confidence because investors believe that the corporation's conducts would be legal and ethical when there is a strict governmental supervision and control. According to Shleifer and Wolfenzon (2002), when better legal protection is guaranteed, investors become more confident in the long-term sustainability of the organisation and hence they would be willing to pay higher for the stocks. They add that since an improved corporate governance framework can restrict shareholders'

monitoring and auditing costs, it may cut down the expected return on equity and the situation would eventually lead to higher firm valuation (Ibid).

According to a survey conducted by Ishak, Hartini and Noriza (2004) on the annual reports of the 556 public companies listed on the Bursa Malaysia, most of which were from the trading sector, the level of compliance to the corporate governance framework is very high in these firms. The authors add that the level of adherence is significantly high for all corporate governance practices relating to the board of directors (Ibid). As a result, the trading sector companies listed on the Bursa Malaysia are in a position to stimulate the investor confidence, which is a key in determining the stock prices of the organization. In simpler words, corporate governance can have notable positive effects on the performance of trading sector firms listed on the Bursa Malaysia. In the following parts, the independent and dependent variables used for this study are evaluated in the light of corporate governance framework of the Malaysia.

### 3. 1 Board composition

As discussed already, the MCCG 2012 gives particular emphasis to strengthening board structure and composition identifying the importance of directors in promoting good corporate governance practices. According to Abidin et al (2009), board composition simply reflects the “ number of independent non-executive directors on the board relative to the total number of directors”. According to Clifford and Evans, an independent non-executive director is a member of the board who has no direct relationship with the board except for his/her directorship. The Malaysian Code of

Corporate Governance suggests companies to establish a balance on the board of directors with independent directors representing at least on third of the board members. The policymakers believe that this provision of the Code would promote the efficacy of the independent directors in enhancing the neutrality of the board decisions (Abidin et al). The importance of independent non-executive directors on the board is justified by the agency theory, which states that the separation between ownership and control may influence the managers to promote their personal goals at the expense of shareholders. Abidin et al. argue that the presence of independent directors on the board is helpful to curb the opportunistic behaviour of the management and to evaluate the management activities more objectively. A study on the randomly selected 75 companies listed on Bursa Malaysia reveals that board composition positively affects the firm performance (Ibid).

### 3. 2 CEO duality

CEO duality refers to a situation where a chief executive officer (CEO) also performs the roles of the chairman of the board. In the Malaysian corporate environment, CEO duality does not seem to have notable positive impacts on the returns of the shareholders. According to a study conducted by Rechner and Dalton (1989), there is little evidence to assume that maintaining CEO duality is an unprofitable move for a company. However, it is important to note that some previous studies have recognised a negative relationship between CEO duality and corporate voluntary disclosures. To illustrate, Gul and Leung (2004) found that the level of corporate voluntary disclosures were lower when the roles of the CEO and the chairman were combined in

Hong Kong. This study strongly supports the need to separate these two roles. At the same time, the authors add that this negative relationship is not significant when there is a higher representation of independent directors on the board. Hence, it is identified that the active involvement of independent non-executive directors in the board's activities can improve the negative relationship between CEO duality and corporate voluntary disclosures.

According to Abidin et al, the effects of CEO duality on the firm performance have not been well established yet.

### 3. 3 Audit committee independence

One of the major goals of the 2007 Code was to enhance the independence of the audit committee and the internal audit function. According to the Principle 5 of the Code 2012, the Audit Committee has the freedom to check whether the firms' financial statements are in compliance with the applicable financial reporting standards (MCCG 2012). To make it clear, the Code 2012 is committed to strengthening the audit committee independence as it is vital to ensure that the firm's financial statements express a true and clear view of the state of affairs of the business. As a result, the board of directors of a Malaysian public limited company is required to establish an internal audit function, which in turn has the responsibility to report directly to the audit committee (MCCG 2012). The Malaysian government strongly believes that greater degree of audit committee independence is essential to evaluate the internal control mechanisms of the organisation and to deal with its risk management effectively.

### 3. 4 Return on equity (ROE)

Return on equity (ROE) can be simply defined as the amount of net income



returned from the business as a percentage of the shareholders equity and it is a key measure of the firm performance. ROE is a useful financial tool for corporations to measure their profitability through assessing the amount of profit it generated against the amount of money shareholders have invested. A better ROE rate implies that the company is able to offer its shareholders attractive returns on their investments. When an organisation strictly adheres to the corporate governance policies and procedures in practice, it would not be exposed to issues such as accounting fraud or other corporate misbehaviours. In other words, the firm's operations would be ethical and effective at enhancing shareholder values. Hence, it is evident that improved corporate governance practices will have significant positive effects on return on equity, which is a key financial performance indicator.

### 3. 5 Return on assets (ROA)

Return on assets (ROA) is another financial performance indicator used by companies to assess the profitability of their operations in relation to their total assets. The ROA can assist the organisation to evaluate how efficient it is at using its assets to generate income. Since ROA is highly dependent on the industry, it is suggestible for organisations to compare it against their previous ROA figures or the ROA of a similar organisation when it is used as a comparative measure. Management professionals claim that effective adoption of corporate governance practices can assist firms to generate higher amounts of income using their assets. Since good corporate governance can aid firms to deal with risk management effectively, this concept can help the top managements promote optimum utilisation of their resources. In short, corporate governance can positively influence ROA too.

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