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The Relationship between Malaysian Directors and Foreign Equity Ownership: An Institutional Approach

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Abstract

In the aftermath of the Asian financial crisis 1997-1998, there are signs that, corporate governance in Malaysia is gradually converging towards the Anglo-American model. Drawing on the institutional theory, this study investigates a previously unexplored phenomenon in corporate governance reformation, namely the directors' attributes and the level of foreign equity ownership (FEO) in Malaysian companies. This study embraces an institutional theory to examine the antecedents of corporate governance reformation in attracting foreign investors in relation to the directors' attributes. The study's hypotheses are tested using panel data derived from 1,836 observations performed throughout a span of a 12 year period, between 2000 and 2011. The generalised least square (GLS) method was employed to estimate the model after considering the existence of heteroscedasticity and serial correlation problems. Our results indicate that the level of FEO in Malaysian companies is significantly related to foreign directors and multiple-directorships. Interestingly, the results defy the significant relationships of outside directors as generally proposed in extant literatures. The findings from this study may have a wider impact on the regulator bodies in Malaysia, such as the Malaysian Institute of Corporate Governance (MICG), the Minority Shareholder Watchdog Group (MSWG), and other interested parties, in setting up a new policy, designing new rules and strengthening the existent regulations in terms of corporate governance for Malaysian companies in order to attract more foreign investors.

Keywords: Board of director, Corporate governance, Company ownership, Foreign equity ownership, Institutional theory.

1. INTRODUCTION

The flows of international capital to developing countries have had the significant impact on the growth of their economies (Hoti, 2004). It helps to finance investments, simultaneously stimulate economic growth, thereby smoothing out consumption and subsequently increasing the standard of living in the countries (Calvo, Leiderman, & Reinhart, 1996). In addition, Aggarwal, Klapper and Wysocki (2005) assert that the demand for emerging firms' shares can lower their capital cost, thus enable them to compete more efficiently in the global market. However, it is widely claimed in the extant literatures that foreign investors are in adverse position in terms of getting information at hand relative to the local investors (Das, 2014). With incomplete information due to cross-border investment, foreign investors prone to underweight the stock, and prefer to find the stock which they are familiar with (Merton, 1987). The foreign investors decline to invest in stock with the information asymmetry problem. Nevertheless, the information asymmetry problem can be overcome by foreign investors if they invest in firms with a good practice of corporate governance (Das, 2014).

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The foreign investors and its link with corporate governance are given special attention by researchers, especially after the Asian Financial Crisis (AFC) 1997/1998 (Bokpin & Isshaq, 2009). In the context of this study, we argue that some companies would, therefore, have higher proportion of foreign ownership than others. Drawing on institutional theory, and in particular considering the extent to which corporate governance characteristics differ among companies, this study seeks to explore the type of directors that potentially lead to the varying levels of foreign ownership across companies. This study employs institutional theory as this theory is claimed as the ideal theory to better explain the institutional changes of corporate governance reform (Aguilera & Jackson, 2003; Buck & Shahrim, 2005) in Malaysia in the aftermath of AFC 1997/1998. Institutional theory is entrenched in the concepts of *institution* and *institutionalisation* (Meyer & Rowan, 1977). This theory of organisations allows comprehensive views of organisations (Zucker, 1987), and thus, this has become a dominant theory for studying organisations (Suddaby, 2010). Institutional theorists are interested in examining organisational structures, and they attempt to understand the process of institutionalisation over time (Meyer & Rowan, 1977). Corporate governance in Malaysia is claimed to be undergoing transformation, especially after the AFC 1997/1998. The reformation of corporate governance is claimed to be influenced by the institutional forces which firms have to abide by in order to stay legitimate. Most of the key players in the economic system have begun to realise the potential consequences on economies of deficiencies in corporate governance. Initiatives have been taken by the responsible parties to reform their corporate governance with the intention of creating a better image of the country, subsequently attracting more foreign investors. The Malaysian government, for instance, has played a diligent role in ensuring that this goal could be achieved. These influences are generally considered as institutional frameworks (Scott, 1995). Therefore, institutional theory is utilised in this study as an explanatory device for corporate governance changes.

The institutional context is set in Malaysia, at the height of corporate governance reform following the currency crisis 1997-98. Using institutional theory, we analysed the process of investment decision taken by foreign investors to invest in a Malaysian companies and antecedents of director attributes on Malaysian board, in what may be viewed as a reaction to radical changes in the macro environment, the AFC 1997/1998. With this approach we contribute by extending the literature on the convergence/ divergence of corporate governance system. Moreover, the uniqueness of corporate governance system in this Asian country lies on the fact of its weak legal environment and poor governance system (Johnson, Boone, Breach & Friedman, 2000) besides the high level of concentrated ownership, with controlling owners (La Porta, Lopez-de-Silanes, & Shleifer, 1999) cross holding and pyramiding (Haniffa & Hudaib, 2006; Liew, 2007). These special features in the context of external events in Malaysia provide ideal settings for examining these issues.

2. LITERATURE REVIEW AND HYPOTHESES

2.1 Outside Directors Compliance (BCOM)

The Code of Best Practice for Corporate Governance - Code (2000) - stated that board composition should be composed of at least one third (1/3) of independent non-executive directors in order for the board to be effective. This reaction taken by the government of Malaysia to escalate the composition of independent directors on the board, or at least abide to their minimum requirement, was a reaction to the radical changes in the macro environment, specifically the AFC 1997/1998. The nature of the institutional environment in Malaysia coincides with the recommendation made by a few scholars (see Aguilera & Jackson, 2003; Buck & Shahrim, 2005), to utilise institutional theory as the main theoretical lens in order to analyse the process and antecedents of appointing independent directors on a Malaysian board. Besides this, the practice of having a relatively high proportion of outside directors on the board has long been practised by the developed market. Therefore, it is in line with the practice recognised by most of the foreign investors in their home countries, which assumes that foreign investors prefer companies which comply with, or work beyond, this compliance. Thus, through the institutional pressure or coercive isomorphism exerted by other powerful institutions, the adoption of this practice is seen by foreign investors as an indicator of good governance practice in a company, which simultaneously mitigates agency costs and accommodates more vital resources for the sustainability of the company. Therefore, it is hypothesised that:
Hypothesis 1: There is a positive association between the presence of outside directors on the board and foreign equity ownership in the firm.

2.2 Foreign Directorship (DIRFOR)

Institutional theory comes with a perquisite perspective. It is argued that foreign directors on the board, particularly those from the USA and the UK, bring with them the norms and values that emphasise maximising

shareholder wealth. These characteristics are favoured by foreign investors as they also share similar attributes when making investment decisions (Ahmadjian & Robbins, 2005). Usually, in developed markets, there are two means by which foreign investors can promote their interests. They can either use the threat of exit – leaving the company by selling their shares if they are not satisfied with the management, or they can use the voice mechanism through shareholder activism. According to Nooteboom (1999), these two options could be achieved through coercive isomorphism. However, it is argued that, for a developing country like Malaysia, these mechanisms do not fit well with its institutional environment, where shareholder activism is weak and the process of promoting shareholder value is still in the undertaking period (especially after the AFC 1997/1998). It is argued that, in the Malaysian setting, foreign investors strongly prefer the existence of foreign director(s) on the company's board of directors in order to represent and secure their interest in the company. The appointment of foreign board members is likely to send a positive signal to foreign investors as a sign of good governance practice. Therefore, it is hypothesised that:
Hypothesis 2: Foreign directorship is positively associated with foreign equity ownership.

2.3 Multiple Directorships (DIRMUL)

The Bursa Malaysia listing requirements of 2002 require a director to hold no more than 10 directorships in public listed companies, while the number of directorships should be 15 or less for non-listed companies. Recently, this restriction has been tightened by limiting the number of directorships in listed companies from 10 to only 5. In order to be listed in the Bursa Malaysia, the public listed companies (PLCs) in Malaysia, with few other options, have to follow the prescribed requirements. DiMaggio and Powel (1983) assert that the institutional forces exerted by higher organisations, in an effort to maximise shareholder value, place extreme pressure on firms in search of legitimacy to adopt the governance structures of Anglo-American capitalism. This kind of pressure, in the form of force, is translated as coercive isomorphism under institutional theory parlance, which has to be abided by in order to stay legitimate and to be perceived by societal members. Foreign investors should be more confident about placing their investments in PLCs that comply with this rule, as they can be assured that the directors on the board can give a reasonable commitment to maximising shareholder wealth, simultaneously mitigating the agency problem. Therefore, it is hypothesised that:
Hypothesis 3: The level of foreign equity ownership is negatively associated with multiple-directorships.

2.4 Female Directorships (DIRWOM)

Worldwide, gender diversity is amongst the main focal points (Carter, Simkins & Simpson, 2003) for governance reformation (Adams & Ferreira, 2009). Accompanied by the fact that Malaysia has undergone a reformation process in firm corporate governance, gender diversity is an element which needs to be applied to the Malaysian company's board of directors. Many developed countries (for instance, UK, Norway, Spain and Sweden) have stressed the importance of having female directorships (25% - 40% representation on the board) which they claim could enhance board effectiveness in many ways including governance practice (Adams & Ferreira, 2009). From the view of institutional theory, this practice of the developed countries becomes a benchmark for companies in Malaysia when considering the proportion of women on the board. To find legitimacy, as sought by the societal members - for example, institutional shareholding (Singh, 2005) - the mechanism that can be used by companies in Malaysia is mimetic isomorphism, one of the isomorphism mechanisms which were identified by DiMaggio and Powell (1983). Based on the explanation of institutional theory, there is a powerful pressure that pushes the organisations that are confronting uncertainty to initiate the action of imitation. This pressure comes from other successful organisations, particularly from the developed capital markets. Even though it is not possible to make this supposition, based on the facts, arguments and prior studies, it is contestably presented that in Malaysia women directorship implies a positive signal to attract more foreign investment. Thus, it is hypothesised that:
Hypothesis 4: The level of foreign equity ownership in a company is positively associated with women directorship.

3. RESEARCH METHOD

3.1 Data and Measurements

Our study examines the relationship between the level of foreign equity ownership and directors' attributes in Malaysian companies. To achieve our objectives, we used a sample of 1836 Malaysian companies, taking an average of panel data observations which spans for 12 continuous years from 2000 to 2011. The number of sample was drawn based on a few strict rules (listing year, companies' status and type) to ensure that they lead to reliable findings. Data from the year 2000 was chosen because starting from this year, PLC's annual reports were complete and made available at Bursa Malaysia's website. The dependent variable is the percentage of foreign equity ownership (FEO) in Malaysian companies for the years 2001 through 2012. Even though the sample study was taken from the year 2000 to the year 2011, a one year lag was allowed for independent variables to capture the effect on dependent variable. This was performed to ensure that the effect of any changes or actions taken by the companies was considered by foreign investors before they decided whether to increase their shares, to retain or to withdraw their investment from the companies. This study used a set of independent variables that have a potential to effect foreign investors' investment decision. For outside director compliance (BCOM), we used the dummy variable taken as 1 if more than 1/3 of BOD is outside non-executive director, and 0 otherwise, we measured the presence of foreign director(s) (DIRFOR) on the board by using the % of foreign directors on the board, for multiple-directorship (DIRMUL) – a dummy variable taken as 1 if number of additional directorship(s) in other public companies is 7 or above, and 0 otherwise and for women-directorship (DIRWOM) – a dummy variable taken as 1 for the presence of female director(s), and 0 otherwise. The control variables selected are well-known for their important role in influencing foreign investors' decision. The control variables chosen are current ratio (LIQRAT), solvency ratio (DEBRAT), profitability ratio (ROE), firm size (FSIZE), firm age (FAGE), audit firm (AUDF), foreign sale (FSALE) and dividend yield (DIVYI). The data for all variables are collected from companies' annual report.

Model specification

Using GLS regression method, the regression model is estimated as follows:

$$FEO = b_0 + b1BCOM_{it-1} + b_2DIRFOR_{it-1} + b_3DIRMUL_{it-1} + b_4DIRWOM_{it-1} + b_5FSIZE_{it-1} + b_6FAGE_{it-1} + b_7DEBRAT_{it-1} + b_8AUDF_{it-1} + b_9ROE_{it-1} + b_{10}LIQRAT_{it-1} + b_{11}DIVYI_{it-1} + b_{12}FSALE_{it-1} + \alpha i + \lambda t + \mu it$$

4. RESULTS AND DISCUSSION

4.1 Discussion of descriptive results

Table 4.1: Mann-Whitney Test for Continuous Variables

Variables	*Mean*		Mann-Whitney (Sig. 2-tailed test)	***Overall Mean***
	FEO=1 n=251 (13.67%)	FEO=0 N=1585 (86.33%)		
Independent Variables				
DIRFOR	14.38	2.79	0.00	4.37
DIRWOM	5.01	7.42	0.00	7.09
DIRMUL	13.13	8.72	0.00	9.32
Control Variables				
DEBRAT	0.42	0.46	0.00	0.45
DIVYI	2.27	1.98	0.03	2.02
ROE	0.05	0.03	0.05	0.03
FAGE	36.00	29.00	0.00	30.46
LIQRAT	3.46	2.83	0.00	2.91
FSIZE	20.45	19.50	0.00	19.63
FSALE	17.27	11.04	0.00	11.89

Table 4.2: Pearson Chi-squared Test for Categorical Variables

Variables				**Pearson Chi-squared**	
	Total	FEO=1 n=251 (13.67%)	FEO=0 n=1585 (86.33%)		
AUDF					
-Big Firms	1084	69%	58%		
-Non-Big Firms	752	31%	42%		
	1836	**100%**	**100%**	10.815	*0.001*
BCOM					
-Follow	1566	85%	89%		
-Not follow	270	15%	11%		
	1836	**100%**	**100%**	2.922	*0.087*

The Mann-Whitney test was run to ascertain the relationship between continuous variables. This comparison was made between two independent groups in two categories: high FEO vs low FEO. This test is a non-parametric method that makes no distributional assumption, since the earlier distribution test (available upon request) showed that almost all the variables are not normally distributed. The results from Table 4.1, reveal significant differences in 9 out of 10 variables when comparing variables for companies with high FEO and low FEO. The above tables present the means for both groups in order to make comparisons. Overall means (in *italic* text) are included for extra precaution. High FEO companies constitute 13.67% of the total 1836 observations. Under this group, for independent variables, other than outside director proportion (BOUT), the remaining variables have rejected the null hypothesis that the median score is the same for high FEO and low FEO groups. The sig value (p-value) <0.05 rejects H_0 which provides evidence of H_A being true. Interestingly, the means for the number of female directorships is contradictory; high FEO companies show a lower mean value (mean = 5.0) compared to companies with low FEO (mean = 7.42). The mean values for multiple-directorships (DIRMUL) is 13.13%, providing additional proof that companies with high FEO always have higher percentage values compared to low FEO companies (means = 8.72%). It is interesting to note that the proportion of foreign directors (DIRFOR) on the board is five times higher for high FEO companies than for companies with low FEO. Table 4.2 above presents the results for the categorical variables, chi-squared ($\chi 2$) test in this study. There are two categorical variables examined to prove their association with the main categorical variables: foreign equity ownership (FEO). The first categorical variable - audit firm (AUDF) - has proven to have an association (p-value<0.05) with FEO. This indicates that there is an association between firms with high FEO or low FEO in choosing an audit firm for their companies as asserted by Abdullah, Shaari & Hashim (2005), where 69% of high FEO companies choose to hire a big audit firm to audit their accounts compared to only 31% which do not. There is not much difference for low FEO companies where 58% of them hired big audit firms compared to 42% which did not. Outside director compliance show no association with the FEO.

4.2 Discussion of hypotheses results

According to the results from the main analysis, GLS regression in Table 4.3, it shows that only hypothesis 2 and 3 are significant. Thus, we can conclude here that foreign directorship (DIRFOR) has a positive and significant influences with the FEO level in company whereas multiple-directorship (DIRMUL) has a negative and moderate influence with the FEO level in company. The other two variables, BCOM and DIRWOM do not significantly associated with the FEO level in the company. While for control variables, out of eight variables, four variables show significant association with the level of foreign investment in companies.

Table 4.3: Regression Results for GLS Estimation Models

			Model Estimation	
Variables	**H**	**Expected Sign**	**Coefficient**	**z-statistic**
Intercept			-54.515	-12.49***
BCOM	H_1	+	0.289	0.39
DIRFOR	H_2	+	0.465	19.16***
DIRMUL	H_3	-	-1.031	-1.82*
DIRWOM	H_4	-	-0.506	-0.94
Control Variables				
FSIZE		+	3.217	14.23***
FAGE		+	0.020	1.170
DEBRAT		-	-3.333	-3.39***
AUDF		+	1.853	3.49***
ROE		+	0.430	0.640
LIQRAT		-	-0.078	-1.08
DIVYI		-	-0.222	-1.98**
FSALE		+	0.018	1.540
Years dummy				*Included*
N				1836
No of groups				153
Time periods				12
Log likelihood				-6998.7560
Wald Chi-square				824.670***

The main aim of this study is to enhance the understanding of the foreign equity ownership in Malaysian firms and its association with corporate governance mechanisms, in a unique institutional background, Malaysia. In summary, it can be concluded that foreign investors allocate disproportionately more shares to firms that appoint more foreign directors, but disfavour firms with high multiple directorships on the board. An additional perspective is also offered for comprehending the relationship of corporate governance and FEO level in Malaysia, by exploring the corporate governance institutional background through an institutional theory lens. The findings of this study improve our understanding of the association between firms' corporate governance mechanisms and foreign equity ownership. The fact that firms with foreign directorships (DIRFOR) are more likely to attract foreign investors, could possibly suggest that societal pressure plays an important role in the investment decision process. These societal pressures that coercively push firms to adopt shareholder value principles, in this case, the representation of foreign directors on the board, are certainly a cornerstone of Anglo-American style corporate governance. The appointment of foreign directors to the board is perceived by foreign investors as a sign of improved governance, which then becomes the impetus for them to invest in the firm

(Kim, Eppler-Kim, Kim, & Byun, 2010). For multiple-directorship, drawing on the institutional theory perspective, in order to search for legitimacy and to be recognised by society, the PLCs in Malaysia have to follow the prescribed requirements. The pressure placed upon the PLCs by the government of Malaysia is an effort to maximise shareholder value in the form of coercive isomorphism, adopting the governance structures of the Anglo-American system (DiMaggio & Powel, 1983). Foreign investors are argued to be selective in this context, in their attempt to avoid investing in companies where the directors have too many outside commitments, as this can dilute their quality time in the company. Foreign investors are more confident in placing their investment in PLCs that abide by this rule, whereby the directors are expected to give a reasonable commitment to increasing shareholder value, simultaneously mitigating the agency problem. Hence, as indicated by the findings in this study, multiple-directorships imply a negative signal to foreign investors as equally perceived by investors in developed markets.

Next, for female directorship, the earlier presupposition, drawing on the same lens, views the presence of women directorships on the board as one of the crucial factors that could attract foreign investors. However, the results depict a different picture and disprove the idea that the female director(s) could affect foreign investors' investment decisions. Despite many empirical results which present a positive association between women directorships and firm value, which indirectly translates as good governance practice and is preferred by foreign investors in Malaysia, in the light of this study, no significant relationship is recognised. Align with the conflicting result by Abdullah, Ku Ismail and Nachum (2016), it is believed, at this stage that the institutional environment in Malaysia cannot be compared with other developed economies, even though it is moving forwards to achieve that level (Abdullah, 2015). Thus, the presence of women directors on the Malaysian board makes no difference to foreign investors as they view them as only 'tokenism' (Wellalage & Locke, 2013). Finally, for outside director composition, the earlier presupposition drawing on an institutional approach, views the presence of outside directors on the board as one of the main determinants which attracts foreign investors. On the contrary, the result of this study refutes the idea that the proportion of outside directors could affect foreign investors' investment decisions. In fact, it is also suggested that the composition of outside directors on the board does not influence foreign investors to make an investment in the company. This puzzling finding has to be explained carefully, especially in Malaysia's capital market. It is argued that the definition of 'independent' for directors in Malaysia can invite scepticism. Abdullah and Nasir (2004: p.23) assert that it is difficult to justify whether independent directors in Malaysian PLCs are truly independent as "Malaysian companies are very closely held and mostly are family controlled". Nevertheless, the evidence from empirical studies on the effectiveness of independent directors in Malaysian companies in carrying out their duties is limited, and not clearly deciphered (Abdullah & Nasir, 2004).

5. CONCLUSION

In summary, the findings of this study may improve our understanding of the association between firms' corporate governance mechanisms and foreign ownership. For future study, it would be more interesting if the countries of origin of the foreign investors can be traced, as the behaviour of investors could differ by country. The advice was sought from the Bursa Malaysia in order to access this information as it is not made available to the public and PLCs also do not impose to provide the information to Bursa Malaysia. They are requested to provide the proportion of foreign ownership out of the total ownership, but not the investors' countries of origin. Given this limitation, an alternative means of gaining access to the countries of origin of the foreign investors could be determined for future research. There is a possibility that the results would differ if the foreign investors' countries of origin are identified as their background may influence their investment pattern.

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