



OWNERSHIP, CAPITAL STRUCTURE AND FIRM
PERFORMANCE:
EVIDENCE FROM MALAYSIA

BY

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A research paper submitted in fulfilment of the requirement
for the degree of Master of Science (Finance)

Kulliyyah of Economics and Management Sciences
International Islamic University Malaysia

AUGUST 2014

ABSTRACT

Corporate governance in the Asian context has witnessed a critical review and investigation from scholars after the Asian Financial crisis in 1997. This is due to the negative effect of ownership structure, which is concentrated, on minority shareholders. Previous studies considered this problem and tried to propose solutions and proposals to come up with efficient corporate governance mechanism. It has been argued that environment with weak legal protection of minority shareholders and inefficient external market and financial institutions is associated with concentrated ownership structure. Literatures in this context provided contradicted arguments about the effect of concentrated ownership in ensuring efficient corporate governance practice and better firm performance. Earlier studies claimed that dispersed ownership is the most efficient structure, where recent studies argued that block holders, such as families state and foreign, showed better governance practice and better firm performance. Within this debate this study tried to contribute to the literature by evaluating the corporate governance practice in Malaysia by focusing on ownership structure and its effect on firm performance and including a new factor, capital structure, to investigate its potential effect on the governance, and taking agency theory as an underlying theoretical background to explain the relationships. Malaysian firms are characterized with concentrated ownership which provides better environment to conduct this study. Based on data collected from the top 100 largest listed companies in Bursa Malaysia, our results showed that after nearly 15 years from the Asian Financial crisis concentrated ownership is still an important component in the Malaysian firms' ownership structure. The results showed further that managerial ownership and leverage are two governance mechanisms which are not used efficiently in governance. Panel Data analysis showed that ownership structure has different relationships with firm performance measurements, negative with the market based measurement (Tobin's Q), and positive with accounting based measurement (ROA), which indicate for potential expropriation of minority shareholders; where managerial ownership recoded negative relationships with both measurements. Foreign and state ownership have positive association with firm value, but state ownership is insignificant, whilst all ownership types are positively related with profitability. By including leverage as a moderating variable the results showed that moderating effect is significant and implies that leverage should be considered as an efficient corporate governance mechanism to ensure better performance and low agency problem.

خلاصة البحث

شهد موضوع حوكمة الشركات في منطقة جنوب شرق آسيا مراجعة و تحقيق نقدي من طرف الباحثين بعد الأزمة التي لحقتها سنة 1997، و هذا يعود إلى الأثر السلبي الذي سببته هيكلية الملكية، الملكية المركزة، على أقلية المساهمين. بعض الدراسات السابقة التي اهتمت بهذا الموضوع حاولت اقتراح حلول و مقترحات لحل هذه المشكلة من أجل الخلوص إلى صيغة فعالة تضمن التطبيق الأمثل لحوكمة الشركات. لقد وجد أن البيئات الإقتصادية التي تتسم بضعف منظومتها القانونية في حماية أقلية المساهمين بالإضافة هيئات مالية و سوق غير فعالة مرتبطة بانتشار الملكية المركزة في الشركات. في هذا السياق تهدف هذه الدراسة إلى المساهمة في إعطاء أدلة إمبريقية و ذلك بتقييم ممارسة حوكمة الشركات في ماليزيا من خلال التركيز على هيكلية الملكية و أثرها على أداء الشركات و كذلك بإدراج متغير جديد و هو الرافعة المالية لتبيان أثرها في ممارسة الحوكمة. هذه الدراسة اعتمدت أساسا على نظرية الوكالة في شرح طبيعة العلاقات بين المتغيرات. أخذت هذه الدراسة بياناتها من الشركات الماليزية باعتبارها تتميز بمستوى تركيز ملكية عال و الذي يوفر بيئة ملائمة للقيام بالبحث. أظهرت النتائج بناء على عينة تتكون من 71 من أكبر الشركات الماليزية المدرجة في "بورصا ماليزيا" أنه على الرغم من مرور ما يقارب 15 سنة على أزمة جنوب شرق آسيا الملكية المركزة ما زالت تشكل مكون أساسي في هيكلية الملكية. الدراسة كذلك أظهرت أن ملكية المسيرين و الرافعة المالية لا يحضيان بالإهتمام اللازم كميكانيزمات مهمة في ممارسة أفضل للحوكمة. و لتبيان العلاقات بين المتغيرات، الدراسة استعملت الطريقة الإحصائية المعروفة بـ "تحليل البيانات المحدولة" و التي أظهرت أن أثر هيكلية الملكية يختلف حسب المعيار المستعمل لتقييم أداء الشركة؛ حيث كان الأثر إيجابيا على العائد على الأصول أما على القيمة السوقية فالأثر كان سلبيا، و هذا ما يعطي إمكانية لوجود ظاهرة المصادرة و التعسف على أقلية المساهمين. الملكية الأجنبية و ملكية الجهات الحكومية كهوية لها علاقة إيجابية مع أداء المؤسسات إلا أن الملكية الأجنبية فقط لها دلالة. بإدراج الرافعة كمتغير تعديلي أثبتت النتائج أن الأثر التعديلي للرافعة المالية أثبت دلالة على الملكية المركزة و ملكية المسيرين. هذه النتائج تدل على أن الرافعة المالية كميكانيزم لحوكمة الشركات يجب أن يؤخذ بعين الإعتبار لضمان ممارسة أفضل للحوكمة و بالتالي أداء عالي للشركات و تكاليف وكالة منخفضة.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a research paper for the degree of Master of Science in Finance.

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DECLARATION

I hereby declare that this research paper is the result of my own investigation, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

Timezghine Mohammed Rafik

Signature.....

Date.....

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Date

*To my beloved Parents
My family
My friends
To whom struggling to spread Justice and Prosperity
And to all whom inspired me
I gratefully dedicate this effort.*

ACKNOWLEDGEMENTS

In the name of Allah, the Most Gracious and the Most Merciful, All praises due to Allah the Knower and Wise and All blessings and salutations due to his Messenger PBUH. First and foremost, I humbly and thankfully express my sincere gratitude to Allah for his blessings and bounties WHOM guided me and granted me willingness, skills and patience to complete this task in the best conditions.

It is with deep appreciation that I express my thankfulness to my supervisor Asst. Prof. Dr. Razali Bin Haron, to whom I would not be able to complete my research without his advice, experience, time, understanding and kindness.

To my parents whom stand by me during my adventure abroad, whom inundate me with their prayers, love and continuous support, for their sacrifices and encouragement;

To my grandpa Papa Aissa for his love since I was a kid; to my brothers and sisters for their love, and Abdulwadud in particular who makes me smiling whenever I remember him or listen to his voice;

To my family for their love and encouragement; I would never forget our discussions and debates together which has contributed immensely to my personality, thinking and attitude;

To my future partner “My Moon” for her love support, prayers and patience, despite her busyness with her preparation and studying she always kept in touch with me;

I would never forget my friends during my stay in Malaysia, including my best neighbors Mustapha and Achour; I admit that it was one of the best memories in my life. To Ahmed and Nacer for their sincere friendship and honesty, Ahmed Basha for his generosity and helpfulness, Shrifi for his persistence and Hadji for his sense of humor and fun, Taleb Brahim for his inspiration and determination, Kacem Doudouch for his challenge, Houcin for his life experience sharing, and my brothers in Rasaili-Nur program, Yusuf and Mahmud in particular, for their high morals and hospitality, to Irfan from Turkey, Naji from Yemen and many others ...

To all lecturers and staff in the faculty of economics and management science IIUM, in particular Prof. Dr. Ahmed Kameel Mydin Meera for his inspiring thoughts and lectures that gave us a deep awareness of the financial system, and for sister Rahmah in PG Unit for her kindness and helpfulness ...

Without you I would not complete this project ...

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LIST OF ABBREVIATIONS

AFC	Asian Financial Crisis 1997
OECD	Organization for Economic Co-operation and Development
MCCG	Malaysian Code of Corporate Governance
MSWG	Minority Shareholders Watchdog Groups
CEO	Chief Executive Officers
PNB	Permodalan Nasional Berhad
ROA	Return on asset
FIM	Family involvement in management
FIO	Family involvement in ownership
GAAP	Generally Accepted Accounting Principles
ROE	Return on Equity
Tobin's Q	Ratio of the market value of the firm's assets to their replacement cost
GLCs	Government-Linked-Companies
PCG	Putrajaya Committee GLC High Performance,
MOF	Ministry of Finance
KWAP	Kumpulan Wang Amanah Pencen
BNM	Bank Negara Malaysia
EPF	Employees Provident Fund
DEBT	The ratio of total debt to total assets
EBITD	Earnings before interest, tax and depreciation
OLS	Ordinary Least Squares
BLUE	Best Linear Unbiased Estimators
FEM	Fixed Effect Method
REM	Random Effect Method
GLS	Generalized Least Square
KLCI	Kuala Lumpur Composite Index
LM test	Breuch and Pagan Lagrangian Multiplier test
VIF	Variance inflationary factor
SMEs	Small and medium-sized enterprises

CHAPTER ONE

INTRODUCTION

1.1 INTRODUCTION

The purpose of this chapter is to provide an introductory section for the study. The chapter is divided into five sections. The first section covers the background of the study followed by the motivation of the study in the second section. The research questions and objectives are in the third section and the fourth points out the contribution of the study to the existing body of knowledge. The final section outlines the structure of the study.

1.2 THE BACKGROUND OF THE STUDY

The business environment in Malaysia faced remarkable reforms and restructuring after the Asian financial crisis. One of the major factors that contribute to the serious effect of the financial crisis was the concentrated ownership structure. Concentrated ownership structure weakened corporate governance and caused the 1997 Asian Financial Crisis (AFC). Before the AFC, corporate governance was not seen as crucial, neither by the Malaysian authorities nor by the international bodies such as the World Bank. However, after AFC, corporate governance seemed to be the main issue to the AFC and has now become an important matter in many countries including Malaysia. The minority shareholders were badly hit by the AFC due to the negative effect on the performance of the firms (Haniffa & Hudaib, 2006). According to a report published by the World Bank “The Assessment of the Corporate Governance in Malaysia” in 2005, in half of the ten largest publicly-listed firms in Malaysia,

over 60% of outstanding shares are owned by the top five largest shareholders. Similarly, in Malaysian listed firms, the largest shareholder on average holds about one third of the firm's outstanding shares, and 60% are owned by the top five shareholders (Samad & Wilson, 2002). As a result, a series of corporate governance reforms had been initiated by the Asian countries, including Malaysia, between 2000 and 2001 to ensure the best corporate governance practice. This includes the establishment of the OECD-Asian Roundtable on Corporate Governance in 1999, which gathers policy makers, practitioners and experts on corporate governance from the Asian region, OECD countries and relevant international organizations to exchange experiences and to advance the reform agenda on corporate governance while promoting awareness of the OECD Principles of Corporate Governance ("OECD-Asian Roundtable on Corporate Governance," 2012).

1.3 THE MOTIVATION OF THE STUDY

This study examines and investigates to what extent the corporate governance reforms adopted after the financial crisis has improved the business environment in Malaysia. The investigation is done on the different types of block holders and their effect on the firm financing decision and, consequently, on firm performance.

Among the notable efforts been executed by the Malaysian authorities was the introduction of the so called "The Malaysian Code of Corporate Governance" (MCCG) by March 2000. This code was mainly announced to protect the minority shareholders. But since the MCCG was obviously derived from the Cadbury Report (Cadbury, 1992) and the Hampel Report (Committee, 1998) in the UK (FCCG, 2000), the different business environment in both countries, mainly the ownership structure, may affect negatively the effectiveness of the code in Malaysia (Haniffa & Hudaib,

2006). However, as in the other Asian countries, Malaysian business are characterized to have concentrated ownership (Tam & Tan, 2007), where UK business ownership are widely held (Khan, 2006).

In order to effectively implement the code, the Employees Provident Fund (EPF), with other Institutional investors¹ established the Minority Shareholders Watchdog Groups (MSWG) to protect the interests of minority shareholders through shareholder activism and to encourage good governance amongst public listed companies with the objective of raising shareholder value over time. This initiative affects positively the shareholders wealth of the MSWG-targeted firms either long or short term, as well as it increases the stock price by 4.8% on average (Ameer & Rahman, 2009; Wahab, How, & Verhoeven, 2008), But, only the firms that have higher levels of institutional ownership benefited from MSWG activism (Ameer & Rahman, 2009).

Since MSWG targeted only the firms that have state-linked institutional ownership, the other types of concentrated ownership are not considered in MSWG program, which may result in a different impact on financing decision and firm performance.

1.4 THE OBJECTIVE OF THE STUDY

Unlike the past conviction that the dispersed ownership is the best corporate model that allows firms to maximize their value and squeeze the agency problem, recent studies provide empirical evidences that concentrated ownership in the modern corporations provide stability and good corporate governance. Given the fact that the

¹ EPF with four other founding members namely: Lembaga Tabung Angkatan Tentera (LTAT), Permodalan Nasional Berhad (PNB), Lembaga Tabung Haji (LTH) and National Social Security Organization Of Malaysia (SOCSO)

Malaysian corporations are characterized to have concentrated ownership, it is worthwhile to dig in the nature of the relationship and disclose empirically the effect of the other types of concentrated ownership on firm performance by introducing an element in the form of capital structure to see its potential impact on the relationship. In particular, the study will first test whether the identity of the block holders, foreign, state, business group and family; have a distinguished impact on the firm profitability and market performance. Secondly, the study will introduce capital structure as a new factor based on theory into the model to see whether it gives a deep understanding on the relationship between ownership and firm performance.

Firms that are controlled by concentrated block holder are expected to rely more on debt due to non-dilution effect of shareholding. In other words, firms that have diffused ownership, the share of each shareholder in profit will be relatively small compared with firms that have concentrated ownership. Therefore, block holders will avoid issuing more shares to maintain their level of profit share in the firm. Alternatively, they will rely more on debt as fixed cost capital to finance their activities and enjoy the excess profit generated from the firm activities. Additionally, shareholders usually monitor the manager's activities and decisions by issuing more debts. Debt as a fixed cost source of finance in nature creates pressure over managers to watch carefully their decisions and investment strategies in order to avoid financial distress due to the inability to pay firm obligations towards debt holders. In this situation the firm would be exposed to bankruptcy. Thus, firms with concentrated ownership have the ability to align their interests with managers by lowering agency costs and consequently maximize firm value.

Based on the above discussion, and assuming that concentrated ownership lead to better firm performance, the study will answer the following research questions:

- i. Does the concentrated ownership have an effective relation with firm performance?
- ii. How can the block-holder's identity give an explanation for the relation between ownership and firm performance?
- iii. Do firms with high ownership concentration ownership rely more on debt?
- iv. How can firm's strategy towards debt affect the relationship with firm performance?

1.5 THE CONTRIBUTION OF THE STUDY

The study contributes to the existing literature on ownership structure and business environment in Malaysia from different aspects. Firstly, based on updated data, the study will shed more light on the effectiveness of corporate governance reforms (in the ownership context) adopted in Malaysia after 15 years from the Asian financial crisis. This research differs significantly from the leading research in this topic undertaken by Haniffa and Hudaib (2006). While their study used data ranged only from 1996 up to 2000 which is close to the AFC, the regulations and policies implemented to improve the corporate governance in Malaysia, such as the establishment High Committee of Corporate Governance in 2000, would not affect significantly the corporate governance practice. In other words, the pre-crisis period is not enough to be assessed in terms of the effect of new regulations on corporate governance practice. In addition, Haniffa and Hudaib (2006) considered the top 5 substantial shareholders as a proxy to controlling shareholders, while this study used only the first top shareholder which allow this study to investigate the effect of shareholders' identity. In terms of the methodology employed, Haniffa and Hudaib (2006) used pooled data which ignores the individual and time effect, by contrast this

study used panel data which is the best method to capture time and individual effect. Moreover, this study considered capital structure as the key factor in explaining the interacting influence of ownership and these underlying firm practices on firm performance, which is not considered in Haniffa and Hudaib (2006). However, this study anticipates that capital structure provides more insight to the relationship in the Malaysian context. Finally, the study will provide a significant source of information and evidence for stock market dealers by showing whether firms with concentrated ownership can be a good investment opportunity with regards to performance as well as agency problem and firm value.

1.6 THE ORGANIZATION OF THE STUDY

In order to provide smooth and informative together with well-organized research, this study consists of six separate chapters each dedicated to specific purpose as follows:

The first chapter provides a comprehensive introductory section which includes the background of the study followed by the motivation of the study and research objectives finalized by the contribution of the study and how the study is organized.

The second chapter reviews important previous literature related to the scope of study which is divided into two main parts; first for previous literature related to ownership and capital structure, and the second review of literature related firm to performance measurement.

The third chapter offers a theoretical background of the study built fundamentally based on agency theory, and the following part consists of research hypothesis.

The fourth chapter provides the methodology employed in this study which consists basically of two main parts; firstly, the hypothesis development and measurement where it goes through definition of variables used in this study, and secondly data and measurement which gives details about sample, data and research design.

The last but not least, the study reports and discusses the findings in chapter five including model specification testing and regression results.

Finally the study concludes with a comprehensive summary of the study, and provides policy implications, limitations and recommendation for further studies in chapter six.

CHAPTER TWO

LITERATURE REVIEW

2.1 INTRODUCTION

The topic of corporate governance including its various embranchments has been seen as big importance among scholars especially the topic of ownership structure and its effect on firm performance. The studies were based on various approaches such the legal approach, the agency approach and others where they reported different results and arguments. For example, recently the topic of family ownership attracted researchers as it provided new form of efficient corporate governance. Apart from the effect of the different names of owner; state, foreign corporate, domestic corporate and families, the form of ownership as concentrated and dispersed and their relationship with corporate governance attracted researches who are interested in legal issues. Even though researches in this topic are big, the field is still vast and dynamic which make different issues arising in accordance with energetic corporate world and circumstances including political economical and legal. In this respect this topic is not covered very well in Malaysia. Therefore this study fills this gap. The chapter is divided into two main sections; at the beginning we provide an overview of corporate governance in Malaysia, then the first section covered the previous and recent studies that shed the light upon the different ownership structures (forms and identities and origins) on firm performance. The study focuses as much as possible on the agency theory perspective. In the second section we turn to the different measures of firm performance and evaluate each method and conclude with the most appropriate method. Finally, a summary providing the main points discussed in the chapter.

2.2 CORPORATE GOVERNANCE

The Malaysian code of corporate governance in its 2012 report states that corporate governance is “the process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity realizing long-term shareholder value, ...” The definition can be decomposed into three parts; the first part emphasizes on the mechanisms of the corporate governance that controls the agency cost, where the previous literature proposes six different mechanisms, which are ownership structure (Jensen & Meckling, 1976) capital structure (Jensen & Ruback, 1983) product market competition (O. D. Hart, 1983) take over market (Jensen & Warner, 1988) and managerial remuneration (Jensen & Murphy, 1990). The second part pointed out the tools that are used by these mechanisms in the corporate governance practice to monitor and manage, which are in the form of the disclosure processes such as financial reporting, auditing, and earning statements, as well as board composition and audit committees (Ajinkya, Bhojraj, & Sengupta, 2005; Beekes & Brown, 2006; Eng & Mak, 2003; Karamanou & Vafeas, 2005). The best corporate governance practice is the efficient implementation of tools and mechanisms to ideally distribute the resources and responsibilities among managers, board of directors and other stakeholders to achieve long-term shareholders’ value as well as sustainable business prosperity (Mahmoud, 2013). In other words, to maintain the interests of the various stakeholders; precisely, managers, employees, customers, executive management board of directors and the providers of capital (Morin & Jarrell, 2001); which is addressed in the last part of the definition.

However the critical point and core issue that is addressed by corporate governance is how to balance between managers’ vast and, often, aggressive control over the companies’ activities form one hand and ensure their accountability in

performing this power and control which affect directly the other stakeholders from the other hand (Monks, 2005). This balance cannot be achieved by practicing a specific model since there is no one unique system of corporate governance that can be implemented in all environments. Business environment, social, cultural as well as legal and political framework factors play a major role in shaping a corporate governance system in a particular environment (Blair, 1995).

Unlike firms in developed countries, in developing countries particularly firms in Asian countries are characterized to have concentrated ownership (Claessens, Lang, & Djankov, 1999; Phung & Le, 2013); as well as low leverage in their capital structure. For example in Malaysia, based on 498 firms between 1997 and 2001, De Jong and Nguyen (2008) found that the mean value of leverage measured by book value of long-term debt to market value of total assets is 8.7%. Since ownership structure and capital structure are two of the mechanisms that control agency problem, corporate governance model in these countries are assumed to take different shapes and forms.

2.3 THE INTER-RELATIONSHIP BETWEEN OWNERSHIP, LEVERAGE AND PERFORMANCE

In this section we review and compare the findings from earlier studies. The section starts with previous studies on the relationship between ownership structure and firm performance covering the different types of ownership; managerial and controlling ownership which includes state, foreign corporate, domestic corporate and family ownership. After that we review the studies that incorporate the capital structure and unveil the different finding and interpretations. Finally we go through different firm performance measures from the literature including accounting-based and market-based measures.