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The Relationship between Corporate Governance and Expropriation of Minority Shareholders' Interests

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Abstract

This study empirically examines the relationship between corporate governance and expropriation of minority shareholders' interests Malaysian firms. Using a sample of 73 companies that are screened from the top 100 companies in Malaysia, this study runs multivariate analysis to assess whether minority shareholders' interests are protected by corporate governance mechanism in a company. The results of this study shows that audit committee independence would help reduce the tunneling and/or propping activities in a company. Besides, a company is suggested to have its positions of CEO and Chairman being held by two different persons. In the analysis, this study also controls for several corporate governance variables such as board size as well as CEO's and/or Chairman's financial expertise. In summary, investors may refer to the outcome of this study in making their investments, whereby they are recommended to obtain some information on board mechanisms of a company.

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1. Introduction

Over the past 50 years, corporate governance has received much attention in the corporate world. In the line of academic research, corporate governance is often tested to see its explanatory power in empirical models (Claessens et al., 2002). In the early 2000s, corporate collapses in various developed markets, specifically the Enron and

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WorldCom cases in the U.S. and the Parmalat scandal in the Europe, to name but a few highlighted the importance of a good governance system. Poor corporate governance could make a company vulnerable to risks, which would next lead to financial distress (Farinha, 2003). Zunaidah & Fauzias (2008) further emphasize that a better governance system would prevent the corporations from misusing shareholder funds through questionable practices, especially the minority shareholders' monies. According to Hasan (2009), corporate governance is a mechanism that entails processes and structures which facilitate the creation of shareholder value through management of the corporate affairs in such a way that ensures the protection of the individual and collective interest of all the stakeholders. All over the world, many countries including Malaysia have established a code of corporate governance to boost the confidence of investors in their capital markets.

In Malaysia, the effort to enhance corporate governance practices of public listed companies has been started since 1993. In year 1995, the move from a merit-based to a disclosure-based corporate governance system was further emphasized by the Malaysian Securities Commission. However, after the Financial Crisis in 1997, investors around the globe started to question whether the rules and regulations are effective in protecting shareholders' interests. The Malaysian Code of Corporate Governance (MCCG) was formally introduced in March 2000, which helps minimize the possibility of occurrence of corporate scandals. One problem of shareholders' interests is the tunneling activities engaged by the ultimate owner. According to Riyanto & Toolsema (2008), transferring resources from a lower-level firm to a higher-level firm in the pyramidal chain allows the controlling shareholder to extract economic benefit from the minority shareholders. In other words, tunneling is a process where the controlling shareholders of a parent company intentionally derive economic benefit by directing a subsidiary company to transfer assets to the parent company at a lower value than its actual value. Hence, the shareholders of the subsidiary suffer the loss of the transaction through lower dividend received.

Another concern here could be the propping activity. Propping happens when the ultimate owner of a group of companies with a pyramidal structure transfers its economic resource to its subsidiary to assist them away from financial difficulties through inter-company transaction. This transaction tends to act in the interests of the minority shareholders to ensure the subsidiary has sufficient economic resource in running the business. For at least last two decades, researchers have become increasingly interested in exploring the relationship between CG and expropriation of minority shareholder's interest as there are controversial issues. Although the topic is not unique in the Malaysian context, expropriation is an important issue because it will directly affect the minority shareholders' interest. The minority shareholders, the ones who hold minority share of the company, should have the power as the majority shareholders in exercising their rights. These rights include seeking information, voicing opinion and seeking redresses (Ameer & Rahman, 2009). However, even they possess these rights, but they seem not to be able to practice it well. Satkunasingam & Shanmugam (2006) point out that the role of respect for status as well as power embedded in the cultures of various races in Malaysia is probably the main reason why shareholders do not take legal action to protect their interests. Shareholders who hold little shares seem to have a minuscule presence and this leads them to simply agree with the decision made by the management. This research thus intends to fill a gap in the literature, by expanding this line of enquiry into the Malaysian context to examine the relationship between corporate governance and expropriation of minority shareholder's interest.

Based on the above discussion, this paper aims to determine whether corporate governance can help minimize expropriation of minority shareholders' interests. This research contributes to the growing body of knowledge in corporate governance from several perspectives. First, this study provides a new insight to the investor about the relationship between corporate governance and the expropriation of minority shareholders' interests. Second, this study acts as a reference for the regulator in developing the relevant rules and regulations. With the result of this study, the regulator would be able to acknowledge the important factors that curb expropriation of minority shareholders' interests.

The remaining sections of this study are arranged as follows. Section 2 presents relevant literature. Section 3 reports data collection and research methodology. Section 4 presents the empirical findings and analysis. Section 5 concludes the paper, proposes some policy implication and future potential studies.

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