

## THE DEVELOPMENT OF SUSTAINABLE HOLISTIC CORPORATE GOVERNANCE INDEX: A MALAYSIAN PERSPECTIVE

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**ABSTRACT:** *The trends in corporate scandals have resulted to people challenging the effectiveness of Corporate Governance and this has increased focus on Corporate Governance disclosure. Similarly, significant attention has been given on how to improve Corporate Governance practices among corporate organizations. This paper presents the process involved in developing a sustainable holistic corporate governance index. The study used a qualitative approach which involved interviews of people from institutional investors, regulators, rating agencies, and academicians. A semi-structured interview was conducted putting emphasis on sustainability. Although there had been a considerable amount of studies on corporate governance index, there are still few studies on the development of corporate governance index from a holistic perspective. The findings from the interviews with the experts in the area of governance revealed that embedding sustainability practices into corporate governance is a holistic approach which could further enhance organization sustainability in the long term.*

**Keywords:** Sustainability, Corporate Governance Index Development, Holistic

### INTRODUCTION

For the past years, corporate governance improvement has followed the shareholder value model [1]. Meanwhile, this model has been discredited as one of the main causes of fraudulent activities among corporate bodies. In order to impede these fraudulent activities, corporate governance needs to be sustainable. Good governance is said to be the cornerstone of corporate sustainability. Therefore, corporate governance needs to encompass and safe guide the interests of all stakeholders. This paper presents the process involved in the development of the holistic corporate governance index. The study used a qualitative approach which involved interviews of people from institutional investors, regulators, rating agencies and academicians. A semi-structured interview was conducted putting emphasis on sustainability. Although there is a considerable amount of studies on corporate governance index, there are still few studies on the development of corporate governance index from a holistic perspective. This development of the holistic corporate governance index commences by conducting interviews with people from the industry and academic to hear their views about corporate governance sustainability.

Corporate governance index is a statistical measure or an indicator that provides the level of corporate governance practices among corporations. Meanwhile, the indices that have been developed so far to measure corporate governance practices among corporate organizations are majorly based on the traditional shareholder value model. This model has been discredited as the main cause of the mismanagement among corporate organisations. These malpractices among corporate organizations prove that the whole system on which corporate entities are built and control is weak and not trustworthy [2]. The study further argued that corporate governance should be applied from a wider perspective, considering the interests of all stakeholders. Therefore, in order to measure the level of corporate governance among corporate organisations holistically, there is a need for holistic corporate governance index to measure the level at which corporate organisations in the country have practiced or implemented the corporate governance from a holistic perspective. The objective of this

paper is to explain the steps or stages involved in the development of the holistic corporate governance index.

### LITERATURE REVIEW

Gompers, et al. [3] developed the G-index. The index was developed using 24 corporate governance mechanisms. The index was used to measure the level of shareholders rights with about 1500 top companies in the 1990s. The study measured companies' corporate governance practices by categorizing the companies into 10 groups based on their G-Index scores. The index was developed by adding one point for every company that makes provision to reduce shareholder's rights. Companies that are found as the highest in a group of ten of the index are considered in the Dictatorship Portfolio and are considered to have strong management power or weak shareholder rights. On the other hand, companies that have the lowest in a group of ten of the index are considered in the Democracy Portfolio and are considered as having weak management power or strong shareholder rights. One major flaw to this index is that it measures shareholders' power in an organisation. The aim is to protect shareholders' interest while other stakeholders' interests are not considered to be important.

Bebchuk, *et al.* [4] further study the significance of the 24 corporate governance mechanism used by Gompers et al. [3] governance index, followed by the Investor Responsibility Research Centre (IRRC) provisions. Their study developed an entrenchment index to measure corporate governance and firm valuation by using 6 out of the 24 corporate governance mechanisms which are: staggered boards, limits to shareholder bylaw amendments, poison pills, golden parachutes, and supermajority requirements for mergers and charter amendments. They developed index by scoring each company under the scope of their study, scores ranging from 0 to 6, according to the number of the mechanisms that the company has in a particular year or period. This index is specifically developed to measure organisations' strength against takeover. It can be considered as takeover control measurement. Organisation that scores high from the entrenchment index is considered to have strong anti-takeover internal control. The issue with this index is that, it

is developed specifically for one particular interest which is measuring organisation takeover strength.

Brown and Caylor [5] also developed an extensive corporate governance index, wider than the G-index and E-index using a new dataset obtained from Institutional Shareholder Services (ISS). Their corporate governance index is popularly known as Gov-Score. The study developed the Gov-Score using 51 factors surrounding 8 corporate governance mechanisms: audit, board of directors, charter or bylaws, director education, executive and director compensation, ownership, progressive practices and state of incorporation. The study used the Gov-Score to measure 2,327 companies' performance, valuation and shareholder pay-out. They developed the Gov-Score by coding the 51 factors surrounding the 8 corporate governance mechanisms as either 1 or 0 based on whether the company's corporate governance practices are acceptable. Each company's scores were summed up to develop Gov-Score.

Commercial providers also provided indices to rank public companies' corporate governance performance based on their research and advisory services. Their indices were different from academic indices on various significant grounds. Their score did not involve addition of regularly weighted factors. Instead, commercial providers develop index by giving weights to different governance factors, either based on their judgment to the significance of the factor or using quantitative analyses to measure the weights [6].

In addition, Governance Metrics International (GMI) which is an independent governance research and rating company established in 2000 to provide institutional investors an unbiased measurement of corporate governance risk as well as governance leaders in their portfolios. This company developed a questionnaire with 100 metrics, each question is awarded a score between 1 and 10 for a particular company [7].

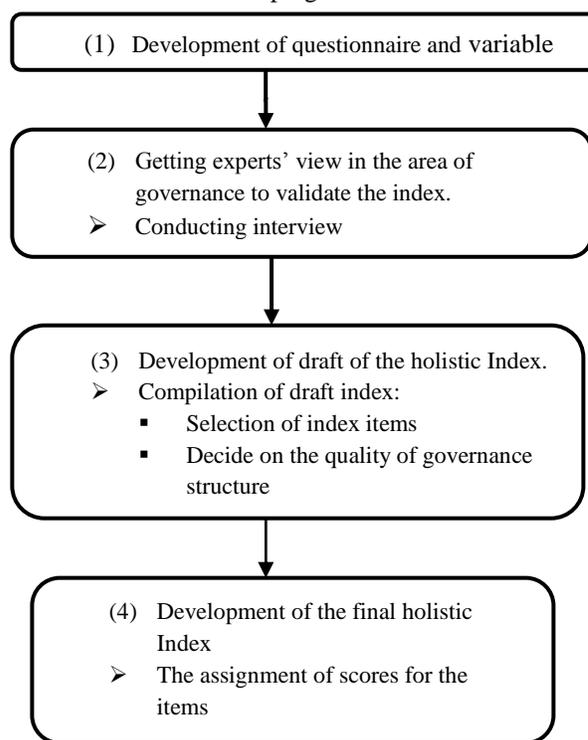
Similarly, Credit Lyonnais Securities Asia (CLSA) [8] an independent brokerage and investment organization, published a study on corporate governance index in 2001. The study reviewed corporate governance level among 25 emerging economies. Each company's corporate governance is measured based on the answers provided in the questionnaire with 57 true or false questions as a method to award figures to the company's corporate governance performance. The questionnaire is categorized into 7 divisions which are: fiscal discipline, accounting transparency or disclosure, board independence, board accountability, responsibility, equitable treatment of shareholders and social awareness. Each division is scored based on the percentage of a true or false answer in that division.

Deminor is another independent consulting company that conducted research on corporate governance for institutional investors. The company used 300 corporate governance factors to measure companies on their governance practices from 4 sides: rights and duties of shareholders, absence of takeover defences, disclosure and board structure. The first side was measured on a scale of 1 to 4, whereas, second and the third sides were measured using a scale of 1 to 5. The

scale they used to measure the fourth side is not disclosed to the public. Development of corporate governance index has been a common practice among researchers and companies. However, the vast majority of the existing studies are on developed countries. Likewise, they tend to be developed to favour shareholders' interest. Similarly, none of the existing corporate governance indices have been developed from a holistic perspective. Therefore, this study intends to fill that gap by developing a holistic corporate governance index.

## RESEARCH METHODOLOGY

The Sustainable Corporate Governance index has been formulated through several processes to ensure the reliability and validity of the index. The following are the four phases process involved in developing the index:



**Figure 1: The four stage process in developing the holistic Corporate Governance index**

### Phase 1: Development of questionnaire and variable measures

The development of questionnaire and variable measures was done with reference to Malaysia Code on Corporate Governance (MCCG) principles (MCCG, 2012) Bursa Malaysia main market listing requirements, ASEAN corporate governance scorecard based on international best practices (ACMF, 2012), the Organisation for Economic Co-operation Development (OECD) principles (OECD, 2004), the World Bank principles (GAC,2012), the United Kingdom Corporate Governance Code (the former Combined Codes, 2012), the International Corporate Governance Network (ICGN) codes (ICGN, 2012), the Australian Securities Exchange (ASX) codes (ASX, 2012), the Global Reporting Initiative on Sustainability Report (GRI, 2013) and the RobecoSAM – Corporate Sustainability Assessment (RobecoSAM, 2013). Questions were developed with

reference to all these codes, reports, principles and assessment. The approach used in developing the questions for this study was from the codes and principles of International Best Practise principles and MCCG codes (2012). Emphasis was put on sustainability to focus on the holistic view of the index. Since there is no theory as of present that gives specific guidance on what to include in a governance quality index [9], then the questions were coined to reflect organisation sustainability.

**Phase 2: Getting experts' view in the area of governance:**

In this phase, seven interviews were conducted with experts in the area of governance. Generally, experts are individual who possess in-depth knowledge or skill based on their experience, education, research or occupation in a particular field of study. The interviews were conducted with two regulatory bodies – Bursa Malaysia and Security Commission, two credit rating agencies – RAM and Malaysian Rating Corporation Berhad (MARC), institutional shareholders - Employees Provident Fund (EPF) and Tabung Haji, institution – Malaysian Institute of Corporate Governance (MICG) and academics. The following are some of the responses from the respondents:

**Table 1 Verbatim Presentation of Experts Responses**

<b>Question 1:</b>	<b>Do you think organization sustainability can be measured using corporate governance?</b>
Responses:	
Bursa Malaysia	<i>"Yes, it is a good idea"</i>
Security Commission	<i>"Yes, it will be a good development"</i>
RAM	<i>"It is a nice approach"</i>
MARC	<i>"That is what corporate governance is meant for in the first place"</i>
EPF	<i>"There should be certain measurement, but Malaysia has not developed to that stage".</i>
Tabung haji	<i>"The country is still young to introduce sustainability practices as corporate governance practice".</i>
MICG	<i>"Organization sustainability is desired, however, sustainability practices are new to the majority of our companies".</i>
<b>Question 2:</b>	<b>How do you think sustainability can be measured among board members?</b>
Responses:	
Bursa Malaysia	<i>"Board members have to be person of good integrity and checking on the board diversity, education background and experience among other relevant personal characters are good approach to measure sustainability among board members".</i>
Security Commission	<i>"It's about the personality of people on the board".</i>
RAM	<i>"It's about the policies initiated by the board. If the board has policies that support or promote sustainability, then they have sustainability. If not, then there is no sustainability".</i>
MARC	<i>"Measuring sustainability among board members is about people on the board".</i>
EPF	<i>"Organization sustainability is all about the</i>

	<i>organization's business model. Therefore, to measure sustainability among board member is about the business model proposed by the board".</i>
Tabung haji	<i>"In most cases, personality does not really vested into it rather the practice the board does in terms of setting in place risk management".</i>
MICG	<i>There should be certain measurement, but Malaysia has not developed to that stage".</i>
<b>Question 3:</b>	<b>What do you see to having Corporate Social Responsibility committee at the board level?</b>
Responses:	
Bursa Malaysia	<i>"It is a good idea"</i>
Security Commission	<i>"It is not necessary to have committee designated for CSR at board level, but companies must ensure that they practice it"</i>
RAM	<i>"Having CSR committee at board level is encouraged"</i>
MARC	<i>"It is better to have it"</i>
EPF	<i>"Though, it is good for companies to practice CSR but there is no need for having CSR committee at board level".</i>
Tabung haji	<i>"It is a good initiative".</i>
MICG	<i>"It is a welcome development as it will help organizations to practice a well-controlled CSR programs".</i>
<b>Question 4:</b>	<b>Do you think that discussion about sustainable development and its implementation should become routine among board of directors of companies?</b>
Responses:	
Bursa Malaysia	<i>"Every organization should talk about its sustainability. Implementing sustainability practices should be part of the board objectives"</i>
Security Commission	<i>"Yes, it is very important"</i>
RAM	<i>"The cost implications have to be considered as well".</i>
MARC	<i>"Sustainable development is a must for companies to talk about. Implementing sustainability practice is encouraged among board of directors".</i>
EPF	<i>"Implementation of sustainability practices among board of directors should be fortified".</i>
Tabung haji	<i>"The cost of implementing sustainability practices need to be considered".</i>
MICG	<i>"The benefit of implementing sustainability practice is for all. Therefore, it is good to implement it".</i>
<b>Question 5:</b>	<b>What is your view about companies adopting sustainability as a core value and business driver?</b>
Responses:	
Bursa Malaysia	<i>"Yes it is a good thing to do. Definitely it's going to make the business to stand out, ethically".</i>

Security Commission	<i>"Undeniably, it is a good approach. Or who will say to be conscious of others' interests is a bad thing".</i>
RAM	<i>"The costs might outweigh the benefits".</i>
MARC	<i>"Morally, that is the best way to conduct business, but are our companies ready for this?"</i>
EPF	<i>"The economic implications to the companies need to be considered".</i>
Tabung haji	<i>"If it is going to profit the company, then it is a good approach. Don't forget we are more concern about profitability".</i>
MICG	<i>"It is a good advantage, to be honest. But we shouldn't forget the environment in which we operate".</i>
<b>Question 6:</b>	
<b>To what extent do you think these stakeholders such as environment, community, and others influence organizational decisions?</b>	
Responses:	
Bursa Malaysia	<i>"To a large extent, they do influence, because we consider them in our investment decision".</i>
Security Commission	<i>"Stakeholders definitely influence organization decisions, to what extent, depends on organization".</i>
RAM	<i>"Stakeholders do influence organizational decisions in some ways. Organizations need to consider its employees, creditors and other stakeholders in its decision making process".</i>
MARC	<i>"Stakeholders are part of organization decision-making process. They make decisions for organizations. So, they have a great influence on organizational decision making".</i>
EPF	<i>"Before we make an investment in any company, we consider the company's relationship with its employees, community and, of course, its profitability. Therefore, I strongly believe stakeholders influence organization decision greatly".</i>
Tabung haji	<i>"To a large extent".</i>
MICG	<i>"The truth is organizational decisions are made by stakeholders. The extent they influence organization decisions is huge".</i>
<b>Question 7:</b>	
<b>Do you think if an organization position itself as responsible organization it will have impact on its financial performance?</b>	
Responses:	
Bursa Malaysia	<i>"When organization position itself as responsible organization and make that its business model, it might not be necessarily having any relationship with the company's financial performance".</i>
Security Commission	<i>"Organization's financial performance at times is determined by other factors besides the organization itself. Therefore, if organization positions itself as a responsible organization that does not guarantee good financial performance.</i>

RAM	<i>"It is a good thing to do".</i>
MARC	<i>"Definitely it will have impact".</i>
EPF	<i>"Responsible organization demands, responsibilities to stakeholders. In a way it is expected to have a positive impact on organization's financial performance".</i>
Tabung haji	<i>"Organization positioning itself as a responsible organization does not give automatic impact on the company's financial performance. But it is a good practice".</i>
MICG	<i>"Absolutely it is good for organization to position itself as a responsible organization and it will have an impact on the organization's financial performance, if not immediately, it will in the long run".</i>

Three of the respondents strongly agreed that organization sustainability can be measured using corporate governance. 1 of the respondents agreed to this question while 3 of them were neutral on this question. Regarding the question on whether sustainability can be measured among members. 3 respondents believed it's about integrity and personality of board member. 1 respondent was of the view that it's about the business model which of course initiated by those on board. 1 respondent opined that it's about risk assessment policy while 1 respondent was of the opinion that no need to measure sustainability among board members. Having corporate social responsibility committee at the board level was strongly agreed to be implemented by 5 respondents, 1 respondent was neutral about the question while 1 disagreed with having corporate social responsibility at the board level. About whether sustainability and its implementation should be habitual among board of directors of an organization, 4 respondents strongly agreed it should be, 1 respondent was neutral and 2 strongly disagreed base on cost implication. 4 respondents strongly agreed that adopting sustainability as a core value and business driver is encouraged while the other 3 respondents also agreed but with a reservation as regards cost of implementing it. All the respondents strongly agreed that stakeholders influence organizational decisions. 2 of the respondents were of the opinion that organization positioning itself as a responsible organization does not guarantee positive influence on the organization's financial performance. 3 of the respondents were opined that it will have an impact on the organization's financial performance. The other 2 opined that it is a good thing to do, but they are neutral regarding its impact on organizations' financial performance. Based on the responses from the experts in the area of corporate governance, this study proceeds to the next phase.

**Phase 3: Development of draft of the holistic index:**

The approach used in the development of first draft for the sustainable scorecard starts with examination of corporate governance codes, principles and corporate sustainability reporting items. This process resulted in the inclusion of 108 items of Corporate Governance items in the initial draft checklist. Since studies have shown that there is no law, principles or agreed upon theory as to the number of items to be included in the index development [9, 10]. This study does not restrict the number of items to be included in the

scorecard. Meanwhile, the recommendations provided by the selected codes, principles and standards are listed out at this stage to ensure that they are accessible from annual reports. In order not to favor any specific stakeholder group, a wide list of items was considered to represent a wide range of stakeholders' interests.

#### Phase 4: Development of the final holistic index:

The approach in this phase is to ensure that all the governance recommendations were taken into consideration followed by checking for any duplicate items among the selected standards. This process led to assigning appropriate governance theme to relevant items under the relevant dimension to develop the final index. After refinement, the final sustainable scorecard consists of 87 items of governance which were unevenly divided into six (6) dimensions: board composition, independent assurance, remuneration committee, nomination committee, audit committee and sustainability [11-15].

#### CONCLUSION

The trends in corporate mismanagement have resulted to people challenging the effectiveness of Corporate Governance. This has increased the focus on Corporate Governance disclosure. Similarly, significant attention has been given on how to improve Corporate Governance practices among corporate organizations. Considerable efforts have been made on how to enhance the quality of Corporate Governance practices among corporate entities to improve the disclosure and transparency. Assessing corporate governance from a wider perspective is of great concern. More importantly, there is a need to develop a holistic corporate governance index in order to measure the quality of corporate governance practices among corporations. This is the primary aim of this study. Based on the responses from experts in the area of governance, this study concludes that embedding sustainability practices into corporate governance is a holistic approach which could further enhance organization sustainability in the long term. The development of the sustainable holistic corporate governance index involves scoring of the level and extent of compliance by the companies with the selected corporate governance principles and best practices. Each of the corporate governance components: board composition, independent assurance, remuneration committee, nomination committee, audit committee and sustainability were awarded scores based on companies' compliance. A basic compliance score was calculated based on the level of compliance with the 87 items of corporate governance practices used in this study. The 87 corporate governance items reflected the principles and best corporate governance practices enjoined by the Malaysian Code of Corporate Governance (Revised 2012).

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