

Human Governance and Firm's Leverage Decision: Evidence from Malaysian Listed Companies

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ABSTRACT

This paper examines the firm's leverage decision from a new perspective, namely human governance. The sample covers 110 public listed companies in Bursa Malaysia for the period of 2002 to 2011. The objective of this study is to investigate the influences of human governance, namely CEO's attributes (age, founder, tenure, duality, and gender) on a firm's leverage decision through OLS regression models. The moderating effect of CEO ownership on the association between CEO personal characteristics and leverage was evaluated. From the analysis a negative relationship between CEO age, founder, gender and leverage decision and a positive impact between tenure and leverage decision was discovered. The study also shows that CEOs owning shares in a company will more likely to take risks. The conclusion suggests that companies may increase their CEO share holdings so that CEO will align their personal interest with the ultimate goal of a company.

Keywords: Human governance, leverage decision, Malaysia listed companies

INTRODUCTION

The recent decades have seen growing importance placed on research in the issue of capital structure and its determinants.

Since the seminal work by Modigliani and Miller (1958), three major theories have emerged: the Trade off theory (TOT), the Pecking Order Theory (POT) and the Market Timing Theory (MTT). For at least the last 10 years, researchers have devoted significant effort in examining the importance of i) firm structure, ii) ownership structure and iii) corporate governance in explaining the firm's leverage decision. The focus of most empirical work has been on

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market, industry, and firm characteristics. Overall, the results of prior studies prove that firms that are similar in terms of these fundamentals often choose very different corporate leverage. Despite a great deal of interest by previous researchers on the determinants mentioned above in leverage decision, there is surprisingly little empirical evidence linking other potential determinants, particularly from the human point of view. Zwiebel (1996) states that decision of capital structure is voluntarily chosen by the manager. Hasan (2009) argues that corporate governance is a mechanism that entails processes and structure that facilitate the creation of shareholder value through management of the corporate affairs in such a way to ensure the protection of the individual and collective interests of all the stakeholders. While considerable attention has been paid in the past to research issues related to the corporate governance mechanism (Daily, Dalton, and Cannella, 2003), literature on issues of the human role or leadership in helping a corporation realize its potential has emerged only very slowly and in a more scattered way (Salleh, Ahmad, & Kumar, 2009).

Although growing numbers of researchers have considered leadership, this topic remains highly relevant today with the reformation of the traditional economy. Economic growth and structural changes raise new issues concerning the leadership role in a firm's decision making. During the economic reformation, the leader of a firm plays a crucial role in a firm's leverage decision. In other words,

the leader's ownership might provide a control mechanism to discipline the management's self-interest behaviour more in line with the company's objectives, hence improving the performance. Cronqvist, Makhija, and Yonker (2012) state that several researchers have recently taken the position that differences in terms of personal preferences across CEOs may eventually impact firms' capital structure decisions. Blockholders with high control motivations would definitely prefer to choose external financing and maintain their authority in a firm's decision. Indeed, financial economists have recently examined some observable CEO characteristics as potential determinants of corporate leverage. This implies that it is important to know the effect of CEOs characteristics towards the capital structure in order to make strategic decisions. Thus, this study believes that there should be an association between leadership personal attributes (various types of human characteristics) and a firm's leverage decision.

Jensen and Meckling (1976) point out the divergence of interests between managers and shareholders of firms with dispersed ownership structure in an agency problem. They conclude that separation between ownership and control in company creates agency conflicts. Berger, Ofek, and Yermack (1997b) explain empirically that entrenched managers who are not effectively disciplined by governance mechanism prefer lower debt ratios. Friend and Hasbrouck (1988) further explain that managers have their own personal agenda

in firms in ways that benefit themselves personally. With this opportunistic behavior, managerial insiders will tend to avoid taking any risk due to their personal wealth. One of the options is to use less optimal amount of debt in order to reduce the bankruptcy risk. Fosberg (2004) agrees that agency problems arise because managers have the opportunity to use assets of the firm in ways that benefit themselves personally but decrease the wealth of the firm's shareholders. Kim, Rhim, and Friesner (2007) pointed out a crucial issue for a firm's shareholder on how to induce management to make decisions that maximize shareholder wealth while minimizing agency costs. One alternative to increase a blockholder's control and reduce agency costs is through increasing debt.

Many researchers discussed the relationship between CEO ownership and debt financing, but little has been done in the Malaysian context. Prior researches that investigated debt financing focused on various areas (i) political connection (Fraser, Zhang, and Derashid, 2006; Gomez, 2002; Johnson and Mitton, 2003); (ii) theories comparison (TOT vs POT) (Suhaila and Wan Mahmood, 2008; Yau, Lau, and Liwa, 2008); (iii) firm characteristics (Pandey, 2004); (iv) ownership structure (Suto, 2003). However, no studies empirically examine the capital structure of human governance in Malaysia. Thus, this paper attempts to bridge the gap and shed some lights to the literature. This study extends prior researches in this area by investigating the impact of CEO personal characteristics on leverage decision in Malaysia. Furthermore, the paper wishes to evaluate the interaction effect between

CEO personal characteristics and their share holdings on a firm's leverage decision. With that, we hope to provide some relevant information to the market players on the accountability and transparency of Malaysian listed firms in validating their firm leverage decision. In other words, it is important for Malaysian listed companies' shareholders to identify the consequences of CEO intervention through ownership.

This paper makes several contributions to the literature. First, this study uses a larger data sample and a longer study period than the previous studies in the literature. Second, the sample is divided into two groups, without CEO ownership and CEO ownership, in order to make a further comparison on the influence of CEO personal characteristics from a human governance point of view. Third, the paper also makes a methodological contribution. This study improves from the prior researches by employing different methods (pooled regression, fixed effects or separate regression tests) for the analysis. Fourth, the paper presents fresh evidence on the interaction between CEO personal characteristics and CEO ownership in affecting a firm's leverage. It is hoped that the findings of this study can serve as an indicator in assessing the impact of human governance on a firm's leverage decision.

The remainder of this paper is organized as follows: Section 2 reviews the literature. Section 3 records the data and methodology while Section 4 shows the empirical findings and discussions. Finally, a conclusion and recommendation are presented in Section 5.

LITERATURE REVIEW & HYPOTHESES DEVELOPMENT

CEO Age and leverage

Richard and Shelor (2002) agree that age changes an individual's perspective, belief systems and network. Vroom and Pahl (1971) further explain that older managers tend to be more risk averse whereas young managers are more willing to undertake risky innovative growth strategies.

Therefore,

H₁: CEO age will be significantly negative related to a firm's leverage decision.

CEO Founder and leverage

A CEO is believed to have greater personal identification with and commitment to the firm, as well as a higher level of trust from the firm's employees than a nonfounder-CEO. Fischer and Pollock (2004) claim that the CEO founder's involvement in the growth and success of a firm since its perception may motivate the CEO to derive the benefits of a firm.

Therefore,

H₂: The presence of a founder-CEO will be significantly positive related to firm's leverage decision.

CEO tenure and leverage

Other than ownership percentages, tenure is another important attribute to describe CEO characteristics as tenure reflects CEO experience and affects their level of risk aversion. Murphy (1999) shows that CEO

tenure is negatively related to performance. They argue that as CEO experience with the firm increases, the boards of directors have more opportunities to observe CEO behaviors over time such that they can assess CEO productivity more accurately. Moreover, Berger, Ofek, and Yermack (1997a) argue that CEOs with longer tenures are more likely to avoid risk. The results indicate that if a CEO services a firm longer, he may become more conservative and inclined to borrow less. This result is further supported by the finding of Bertrand and Schoar (2003). The authors found that older generations of managers, on average, are financially more conservative. They find that executives' risk aversion is positively correlated with their age (positively related to tenure) and firm leverage is negatively related to executives' age. For instance, Abor (2007) found that there is a negative relationship between the tenure of the CEO and capital structure, suggesting that, entrenched CEOs employ lower debt in order to reduce the performance pressures associated with high debt capital.

Therefore,

H₃: There is a significantly negative relationship between the CEO tenure and a firm's leverage decision.

CEO duality and leverage

Besides that, many previous studies also look into CEO/Chair duality and they believe that it is also one of the important features to describe CEO characteristics.

Morck, Shleifer, and Vishny (1988) argue that the role of CEO and chairman should be separate, as the CEO is the chief decision management authority and the chairman is the chief decision control authority. Fosberg (2004) suggests that a dual leadership structure is effective in increasing the amount of debt in a firm's capital structure. However, Abor (2007) concluded that there is a positive relationship between CEO duality and capital structure. Almeida, Ferreira, and Adams (2005) report that if a CEO is also the chairman of the board of directors, the powerful CEO tends to choose more aggressive capital structure. The result implies that as CEOs become more entrenched, they are more likely to take risk.

Therefore,

H₄: There is a significantly positive relationship between CEO duality and a firm's leverage decision.

CEO gender and leverage

Apart from CEO duality, gender is another main variable to describe the characteristics of CEO. Coleman and Cohn (2000) find that there are no significant differences in the usage of debt between men and women, and gender is not a significant predictor of financial leverage. In contrast, Abor (2007) argues that women-owned businesses are less likely to use debt for a variety of reasons, including discrimination and greater risk aversion. The result is consistent with Faccio, Marchica, and Murac (2012) who agree that firms run by female CEOs have lower leverage, less volatile earnings, and a

higher chance of survival than firms run by male CEOs. Moreover, Heminway (2007) argues that women are more trustworthy than men, and are thereby less likely to manipulate corporate financial and other disclosures.

Therefore,

H₅: Male CEOs prefer more debt.

DATA AND METHODOLOGIES

Sample Selection

This study is conducted by collecting the secondary data from Bursa Malaysia and other variables from DataStream. Of the 831 companies listed on the Main Board of Bursa Malaysia as at 3 September 2012, we managed to collect data for 793 companies after excluding the financial sector. From the 793 companies, we found only 310 companies with data available from 2002 to 2011. Further, we excluded the companies which lack data such as CEO information, firm size, etc. based on DataStream. At last, we managed to finalize 110 public listed companies from 7 sectors (Plantation, property, consumer, construction, trading and service, technology and industrial product) for 10-years period with full data available.

Variables and Measurement

As in Table 1

Research Model

$$\text{LEVE}_{it} = \alpha_0 + \alpha_1 \text{HG}_{it} + \delta' \text{CONTRL}_{it} + \varepsilon_i \quad (1)$$

TABLE 1
Variable measurement

| Variables | Description | Prediction |
|--|--|------------|
| <i>Explanatory variables</i> (Human governance-HG) | | |
| CEO Age(CEOA) | The numeric variable expressing age of an executive adjusted by year. | - |
| CEO-Founder (CEOF) | Dummy variable which code as 1 if the founder of the company is CEO at the time and 0 otherwise. | + |
| CEO Tenure (CEOT) | Number of years in CEO position for firm. | - |
| CEO duality (DUA) | A dummy variable, 1 = if CEO is chairman, 0 = is otherwise | + |
| CEO gender (GEN) | A dummy variable 1 = if firm male-owned, 0 = is otherwise | + |
| <i>Moderating variable</i> | | |
| CEO Ownership (CEOOW) | Percentages of shares owned directly by CEO | |
| <i>Control variables</i> | | |
| Return on Assets (ROA) | Net Income divided by Total Assets | |
| Size (SIZE) | The natural log of total assets | |
| Board independence (BIND) | Number of independent non-executive directors | |
| Board Size (BSIZE) | Number of directors | |
| Dependent variables | | |
| Leverage (LEVE) | Total debts to total assets | |

where α_0 is the constant term of equation 1. α_1 as coefficients of the independent variables. δ as coefficients of the control variables. ϵ_{it} is the error term. Subscript i and t in equation 1 represent the firm and time, respectively. In this case, i represents the cross-section dimension and t represents the time series component.

LEVE is a measure of capital structure namely leverage. It is common to only use total debts to measure capital structure in analysing leverage antecedents (Ting and Lean (2011)). CONTRL is a vector of control variables including ROA (a measure of return on assets), SIZE (a measure of size), BIND (a measure of board

independence) and BSIZE (a measure of board size).

$$\begin{aligned} LEVE_{it} = & \beta_0 + \beta_1 HG_{it} + \beta_2 CEOOW_{it} \\ & + \beta_3 (HG_{it} \times CEOOW_{it}) \\ & + \delta' CONTRL_{it} + \epsilon_{it} \end{aligned} \quad (2)$$

Equation 2 is designed to evaluate the interaction effect between CEO personal characteristics and CEO ownership in affecting a firm's leverage. CEOOW is a measure of CEO ownership. It is measured as percentages of shares owned directly by CEO.

EMPIRICAL RESULTS

Descriptive Statistics

The following Table 2 provides the descriptive statistics for both companies with CEO ownership and companies without CEO ownership. Companies with CEO ownership account for approximately 71.8 percent of the total sample companies. The findings for difference-in-means tests are summarized as follows. CEOs with ownership are significantly elder than those without ownership. Moreover, most of the CEOs with ownership are founders of the companies, as compared to CEOs without ownership. The average tenure of CEO with ownership is about 15.907 years, which is significantly longer than that of CEO without ownership (10.764 years). Moreover, CEOs with ownership have a significantly higher percentage of the combination of Chairman and CEO positions than those without ownership. From the findings, it is known that most of the CEOs are male. In terms

of the control variables, only a significant difference between the mean of SIZE was found. In summary, statistically significant differences on the main testing variables between companies with CEO ownership and companies without CEO ownership were found. However, the univariate test is weak in that it does not control the variables used simultaneously in an empirical model. Therefore, a multivariate regression analysis was run to provide a more robust test to evaluate whether CEO ownership strengthens the relationship between leaders' attributes and the level of leverage.

To determine whether differences in leverage exist among the various industries (Plantation, Property, Consumer, Construction, Trading/Services, Technology, and Industrial Product), a non-parametric statistical analysis (Kruskal–Wallis test) was used. Table 3 lists the results. The findings show that companies in the trading or services industry have the highest mean

TABLE 2
Descriptive statistics of independent variables

| | With CEO Ownership (N = 797 firm-year observations) | | Without CEO Ownership (N = 313 firm-year observations) | | Difference in Means (<i>t</i> -stat) |
|-------|--|-------|---|-------|---|
| | Mean | S.D. | Mean | S.D. | |
| CEOA | 52.966 | 7.746 | 50.655 | 9.091 | -4.253*** |
| CEOF | 0.319 | 0.466 | 0.118 | 0.323 | -6.976*** |
| CEOT | 15.907 | 9.525 | 10.764 | 9.861 | -8.015*** |
| DUA | 0.280 | 0.449 | 0.166 | 0.373 | -3.972*** |
| GEN | 0.991 | 0.106 | 0.971 | 0.167 | -2.370** |
| ROA | 0.052 | 0.116 | 0.053 | 0.145 | 0.120 |
| SIZE | 12.197 | 1.376 | 12.642 | 1.669 | 4.552*** |
| BIND | 0.425 | 0.108 | 0.430 | 0.117 | 0.650 |
| BSIZE | 7.493 | 1.822 | 7.419 | 1.855 | -0.610 |

Note: *, **, and *** denote the statistical significance at the 10%, 5%, and 1% level, respectively.

TABLE 3
Test of difference on the dependent variable

| Industry | Leverage (The ratio of total debts to total assets) | | | | | | | Overall |
|------------------------------|---|---------|---------|---------|---------|---------|---------|---------|
| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | |
| Mean | 0.383 | 0.455 | 0.436 | 0.431 | 0.467 | 0.465 | 0.473 | 0.457 |
| (Median) | (0.305) | (0.473) | (0.414) | (0.392) | (0.454) | (0.391) | (0.434) | (0.434) |
| Kruskal-Wallis teststatistic | 12.657** | | | | | | | |

Note: 1 to 7 represent the plantation industry, the property industry, the consumer industry, the construction industry, the trading/services industry, the technology industry, and the industrial product industry, respectively.

(median) leverage of 0.467 (0.454). This could be because the sector has the highest average total liabilities, long term liabilities and short term liabilities, and followed by those companies from Construction and Property sectors which is consistent with Mustapha and Ismail (2011).

The Relation between Human Governance and Performances

Before the final OLS regression was performed, some diagnostic tests were carried out. First, the diagnostic of variance inflation factors (VIF) was conducted but no evidence of collinearity among the variables in our regression models was found.¹ Second, a check for heteroskedasticity of residuals in Equations (1) and (2) using White test (White, 1980) was done. The results suggest (White, 1980) that heteroskedasticity-consistent standard errors to report our significance levels be used.

Table 4 presents the OLS regression results. The two equations are statistically significant with F-statistics of 22.683 and

¹ VIF values: CEOA = 1.687, CEOF = 1.826, CEOT = 1.704, DUA = 1.723, GEN = 3.160, ROA = 1.523, SIZE = 2.016, BIND = 2.704 and BSIZE = 1.802

15.104, respectively. The results of Equation (1) show that the coefficient on CEOA is negative and statistically significant, suggesting that elder CEOs tend to be more risk averse and thus taking less debt. This finding supports our hypothesis. Of the main variables, we also find statistically significant and negative coefficients on CEOF and GEN. These results imply that founder-CEOs may also avoid risk to benefit themselves. Furthermore, nonfounder firms benefits from greater monitoring which presumably leads the firm to distinguish genuine entrepreneurial opportunities hence need more debts as compared to founder firms (Randøy & Goel, 2003). Although some prior studies show that male CEOs prefer debt, it is demonstrated that male CEOs will take less risk, after controlling for the impact of other relevant variables. Also of interest to this study are CEOT and DUA. The results show positive coefficients on CEOT and DUA. However, only that of CEOT reaches the conventional significance level. The results indicate that a long-serving CEO may become less conservative and inclined to borrow more. This could be because a CEO having served a company

for a long period has gained experience and thus is more tactful in taking risks.

To highlight and evaluate the impact of CEO ownership on the association between leadership's attributes and leverage, an interaction variable between the five leadership's attributes and CEO ownership was included. Based on the results of Equation (2) in Table 4, the interaction terms are all positive, with the interaction terms on CEOF*CEOOW, CEOT*CEOOW, and GEN*CEOOW reaching the conventional significance level. These results noticeably illustrate the advantages of CEO ownership in a company. In other words, the higher the

CEO ownership in a company, the more likely the CEO is to take risk. For brevity purpose, the results on the control variables are not discussed.

Robustness Test

To ensure the robustness of the results, our dependent variable was replaced with another proxy, viz. debt to capital ratio. The tenor of the results is not changed for both Equations (1) and (2). This indicates that human governance indeed has influence on corporate leverage decision. Moreover, these results are robust to estimation across subsamples. That is, the sample was

TABLE 4
OLS regression (N = 1,110 firm-year observations)

| Variable | Equation (1) | | Equation (2) | |
|-------------------------|--------------|---------|--------------|---------|
| | Coefficient | p-value | Coefficient | p-value |
| Constant | 0.579** | 0.010 | 0.652*** | 0.005 |
| CEOA | -0.005*** | 0.000 | -0.004*** | 0.000 |
| CEOF | -0.053*** | 0.006 | -0.068** | 0.010 |
| CEOT | 0.002** | 0.015 | 0.003*** | 0.000 |
| DUA | 0.017 | 0.542 | 0.023 | 0.473 |
| GEN | -0.193*** | 0.005 | -0.199*** | 0.006 |
| ROA | -1.116*** | 0.000 | -1.084*** | 0.000 |
| SIZE | 0.039*** | 0.001 | 0.034*** | 0.007 |
| BIND | -0.013 | 0.884 | 0.000 | 0.999 |
| BSIZE | -0.016*** | 0.005 | -0.020*** | 0.001 |
| Interaction terms: | | | | |
| CEOOW | | | -0.011 | 0.180 |
| CEOA*CEOOW | | | 0.000 | 0.250 |
| CEOF*CEOOW | | | 0.003* | 0.052 |
| CEOT*CEOOW | | | 0.000*** | 0.000 |
| DUA*CEOOW | | | 0.000 | 0.786 |
| GEN*CEOOW | | | 0.016** | 0.013 |
| Adjusted R ² | 0.150 | | 0.161 | |
| F-statistic | 22.683*** | | 15.104*** | |

Note: *, **, and *** denote the statistical significance at the 10%, 5%, and 1% level, respectively.

partitioned and separate regression tests were run on the two groups (companies with CEO ownership vs. companies without CEO ownership).

Finally, OLS may not adjust for firm-specific or year-specific effects, which would cause an omitted variables bias problem. The fixed-effect model and random-effect model can solve this problem through the firm-specific or/and time-specific intercepts. A Hausman test was conducted to decide whether to employ a fixed-effect model or a random-effect model. The Hausman test statistics (P-value < 0.05) suggest the use of a fixed-effect specification. The results shown in Table 4 continue to hold when fixed-effects panel data regression analysis, which in a way supports our use of OLS as the main procedure was run. It is to be noted that the data set of this study is a panel data set.

CONCLUSION

This study examines the relationship between a CEO personal characteristics and a firm's leverage decision for the period from 2002 to 2011. The moderating effect of CEO ownership on the association between CEO personal characteristics and leverage was also evaluated. The findings can be summarized as follows. (1) CEO age is significantly and negatively related to leverage; (2) a founder-CEO is significantly and negatively related to leverage; (3) CEO tenure is significantly and positively related to leverage; (4) CEO duality is positively related to leverage, but it is not significant; (5) CEO gender

is significantly and negatively related to leverage; and (6) CEOs owning shares in a company will more likely to take risk. While having leverage means higher risk, it is suggested that companies may increase their CEO shareholdings so that CEO will align their personal interest with the ultimate company's goal.

While there may have been other incentives that have not been examined, it is shown that the most obvious (at least to us) is possible CEO personal characteristics in determining leverage decision. While this study is based on a relatively small sample, and hence has to be viewed as suggestive only. One obvious future empirical extension to this study is to explore the effect of CEO experience, CEO perspective, and CEO race on cost of debt. It was also particularly time-consuming to hand collect the CEO information from the annual reports of our sample companies.

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