THE PROVISION OF VALUABLE RESOURCES BY INDEPENDENT DIRECTORS THROUGH POLITICAL CONNECTIONS: A STUDY OF FAMILY-CONTROLLED, PUBLICLY-LISTED COMPANIES IN MALAYSIA

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ABSTRACT

Due to massive expansion of the government engagement in the economy in Malaysia, business entities were dependent on the government and ruling political parties’ patronage. This becomes more critical in family-controlled companies as the higher is the family ownership concentration, the more external linkages, networks and resources are required. This is because of family-owned companies’ nepotism approach in hiring insiders from their close circles which limits their access to institutional environment and external resources. Thus, appointing independent directors with political connections who will not be involved in the day-to-day running of the company facilitates their access to government contracts, licenses, soft loans, etc. With a random sample of 200 family-controlled companies listed on Bursa Malaysia in 2008 and using partial least squares structural equation modeling, we find that publicly-listed companies with higher family ownership concentration appoint more independent directors who have strong connections with the government and ruling political parties and this enhances their financial performance.

JEL Classifications: G34, G32, M40

Keywords: Family Ownership, Resource Dependence Perspective, Government and Political Resources, Independent Directors, Malaysia.

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INTRODUCTION

The development of capitalism in Southeast Asian countries in general, and Malaysia in particular, has often been seen as a prime example of a close “nexus of business, politics and the state” (McVey, 1992, p. 9). In fact, in the case of Malaysia, the boundaries between politics, state, and business have become more and more intertwined to the stage where “it is no longer easy in many cases to distinguish between rent seeking and true productive capitalism between pariahs and entrepreneurs or between patrons and clients” (Searle, 1999, p. 1).

However, despite similarities, in terms of capitalism development, between Malaysia and other Asian and Third World countries, there are significant differences as well which makes each country a unique distinctive. It is because corporate governance in every country is path-dependence influenced by its institutional culture (Bebchuk & Roe, 1999; Gomez, 1999; Licht, 2001; Is & Batten, 2001) which gives unique attributes to each country and is shaped over time (Kuada & Gullestrup, 1998).

Malaysia is a developing country with considerable division in terms of race, ethnicity, culture, religion, customs, and language (Rahman & Ali, 2006; Peow, 2011). The Malaysian population consists of three major ethnic groups. In 2010, Malays were 60%, Chinese 23%, and Indians 7% of the population. (Demographic Statistics Division, 2011).

Chinese and Indians presence in Malaysia dates back to the colonial period when the British colonial government with the aim of capitalist expansion brought Chinese and Indian workers to Malaysia in order to employ them in tin mines and rubber plantations (Rahman & Salim, 2010). Although some non-Malay were hired in the government technical services, due to the British strategy of designating Malays as the ruling class, the higher levels of the bureaucracy and politics were in hands of Malays as the major ethnic group in the country (Crouch, 1996; Heng, 1997).

Over the years, the Chinese who were the more business oriented and entrepreneurial group dominated and controlled the extensive part of the economy and business in Malaysia (Gomez & Jomo, 1999). Their monopoly of business activities fuelled the imbalance between races and weakened economic position of Malay in the time of the country weak economy after the independence in 1957, Malays’ dissatisfaction with their poor economic condition as well as the significant economic inequity between Malays and Chinese triggered racial riots in 1969 (Jayasankaran & Hiebert, 1997; Searle, 1999).

To alleviate this critical situation, the New Economic Policy (NEP) was launched by the government in 1971 to correct economic imbalance, so as to reduce and eventually eliminate the identification of race with economic function (Crouch, 1996; Hensley & White, 1993; Roslan, 2001). To do so, NEP privileges Malays in accessing to licenses, government contracts, credits, jobs, educational scholarships etc. (Balasubramaniam, 2007).

However, the government realized that despite the granted prerogatives, Malay could not simply start businesses and compete with the well-established Chinese dominant economic power and foreign companies. Thus, the Malaysian state set up several trust agencies to help Malays to start up their businesses or enter into business activities themselves on behalf of Malays (Crouch, 1996; Farouk, 2012).

In effect, the implementation of the NEP led to significant discrimination in favour of Malays against non-Malays. However, in practice, despite these supports and actions, the major Malay businesspeople became from three groups: those with linkage with UMNO, those with current or former positions in the government, and royalty and the government became one of the major players in the Malaysia’s business to filled Malay’s vacancies and act on behalf of them (Crouch, 1996).

Meanwhile, in adjusting to the government actions in the 1970s and 80s, Chinese enterprises adopted different strategies in order to directly or indirectly link to UMNO leaders, local Malay politicians and the government which expanded the involvement of the government in the business too.

In summary, there was a massive expansion of the government engagement in the economy in the post-NEP era which limited the political power of business class. “Not only did the large size of the state sector reduce the political weight of the private sector but many private businesspeople, both Malay and Chinese, were dependent on the government (that is, UMNO) patronage and closely associated with the state sector in joint-venture and other arrangements” (Crouch, 1996, p. 217). Indeed, although NEP was successful in involving Malays into business and commercial activities, it failed to build an independent Malay entrepreneurial class. Though some Malay businesspeople could build enterprises that can survive without the government support, the predominant Malay business community remained dependent on their political and bureaucratic links in order to access to the government resources and obtain special privileges. Besides, Chinese businesspeople that due to their ethnicity were not qualified to play a bold role in politics, became dependent on the government’s licenses, approvals, and permissions. As a result, they were forced to make partnership with Malays and in practice many of them became clients of Malay politicians and the government (Crouch, 1996; Verma, 2002).

Therefore, this phenomenon resulted in “a range of practices whereby the benefits of State economic sponsorship and protection are channelled to individuals, groups and private companies associated with the
ruling parties, in particular, UMNO,” which led to “blurring of state and UMNO business interests and the increasing dominance of UMNO and UMNO associated enterprises in the economy” (Kahn & Loh, 1992, p. 2).

Meanwhile, family ownership is the predominant form of ownership in companies in Malaysia (Claessens, Djankov, & Lang, 2000; Rahman & Salim, 2010). While family-owned companies are especially prevalent among privately held small and medium-sized enterprises, many of the publicly-listed companies are also classified as family-controlled. For example, previous research shows that Malaysia has the largest proportion of family-controlled publicly-listed companies among East Asian countries with 75% and 70% at 10% and 20% block ownership cut-off respectively (Claessens, Djankov, Fan, & Lang, 2002). The importance of conducting separate studies specifically on family-controlled companies is that they exercise different governance practices compared with professionally managed dispersed-owned companies (Daily & Dollinger, 1992). For instance, the larger is the proportion of wealth/ownership, the more dependent are the controlling families’ wealth on these companies’ performance and market valuation (Silva & Majluf, 2008). Therefore, concentrated family ownership is likely to result in lower managerial slack and lack of monitoring. This is especially true since most family members also assume top management positions such as CEO within their respective companies. Hence, this research postulates that higher family ownership concentration leads to higher company performance and the first hypothesis is developed as follows:

**H1:** Family ownership concentration has a significant positive effect on financial performance of publicly-listed companies in Malaysia.

On a related development, since the board of directors of family-owned companies often consist almost exclusively of family members, close friends, as well as business associates (Young, Ahlstrom, Bruton, & Chan, 2001), this limits their network connections to the wider environment. In such a situation, we predict that companies with higher degrees of family ownership concentration require more external linkages, networks and resources through alternative means/mechanisms. Put simply, they would likely prefer to include those who could connect them to the outside resources and contacts but without too much involvement in the day-to-day running of the business itself. In this regard, we contend that independent directors is the ideal group of individuals to fulfil this role (Essen, Oosterhout, & Carney, 2012; Young et al., 2001). Therefore, the second hypothesis is developed as follows:

**H2:** Higher family ownership concentration, publicly-listed companies in Malaysia significantly appoint more number of independent directors having connections with the government and ruling political parties on their boards.

As discussed earlier, in Malaysia, due to very high involvement of the government and UMNO in business, companies have been largely dependent on the government patronage and the government has become one of the most critical resources in Malaysia. More specifically, having close relationship with the government/political parties can facilitate access to governmental projects, secure licences and contracts, monopoly rights, soft loans, and regulatory protection from competition, etc. (Essen et al., 2012; Li & Harrison, 2008; Yoshihara, 1988). In fact, most government leaders and politicians make continuous use of the government apparatus to support individuals and groups in return for backing of their respective political parties. It is therefore plausible that family-owned companies would prefer to appoint independent directors with very strong political links in order to reduce external uncertainties. These companies may be bailed out or given benefits that are mentioned earlier probably in return for the company’s future support (Paulevah Sharif & Yeoh, 2014).

Therefore, we propose that the presence of independent directors having connections with the government and ruling political party, UMNO, improves the performance of family-controlled publicly listed companies in Malaysia and the third hypothesis is developed as follows:

**H3:** Number of independent directors having connections with the government and ruling political parties has a significant positive effect on the performance of family-controlled publicly listed companies in Malaysia.

Consistent with the arguments put forth, we argue that companies with higher level of family ownership experience more need for independent directors who connect them to the government and ruling political parties to take benefit from the government resources and privileges. This is because of family-owned companies’ nepotism approach in hiring insiders from their close circles which limits their access to institutional environment and external resources. These independent directors with political connections are likely to play a significant role in the provision and also securing of key resources that their companies require for good
performance (Haniffa & Hudaib, 2006; Ibrahim & Samad, 2011; Pfeffer & Salancik, 1978; Pahlevan Sharif & Yeoh, 2014). Therefore, the fourth research hypothesis is developed as follows:

**H4**: Family ownership concentration has a significant positive effect on companies’ performance through appointing more independent directors with connections to the government and ruling political parties.

**SAMPLE SELECTION and ANALYSIS**

**Sample Selection**

In times of crisis, while the government support and resources become more important, the independent directors’ role will be more salient as well. It is because in the economic downturn the company performance is low and CEO’s bargaining power reduces and as a result directors will be more independent and proactive. Indeed, during crisis period, independent directors by providing required resources to the company moderate the reduction in company’s profit and play more critical role (Francis, Hasan, & Qiang, 2012; Pahlevan Sharif & Yeoh, 2014). Hence, due to the importance of independent directors’ role in the crisis period, this research is conducted in the time of the global credit crisis in 2008.

Samples of this study consist of 200 family-controlled companies that are randomly selected from the main board of the publicly-listed companies in Malaysian stock exchange market, Bursa Malaysia, for the year 2008. Due to the different structures of financial institutions and banks, they were excluded from the study. Family-controlled companies are considered those companies with greater than 10% family’s direct and indirect ownership in the company. We used secondary data which was hand-collected from the annual reports of the companies available on their websites as well as the Bursa Malaysia website. For each independent director, we collected data on links with the government and ruling political parties through content analysis of the annual reports of the selected companies.

**Analysis and Discussion**

Table 1 shows family ownership concentration, average number of independent directors with government and ruling political parties’ linkage as well as proportion of samples across different sectors. As it is shown, 41.50% of family-controlled companies in the sample are in the industrial products sector following by 21% and 15.5% in the trade and services and consumer products sectors respectively. This summary shows that broad sections of the market are relatively well-represented in our sample dataset. Moreover, family ownership varies from 10% to 79.83% in 200 samples of this study. Minimum family ownership is in industrial product (10%) and maximum is in the consumer sector (79.83%). Furthermore, the average number of independent directors having close relationship with the government and ruling political parties in samples of this study is 0.91 which shows a very high presence of independent directors with political connections on the board of family-owned publicly listed companies in Malaysia.

**TABLE 1. SAMPLES PROPERTIES ACROSS SECTORS**

<table>
<thead>
<tr>
<th>Sectors</th>
<th>Number of Companies</th>
<th>Percent</th>
<th>Family Ownership Concentration Max</th>
<th>Mean</th>
<th>Std. Dev.</th>
<th>Average No. of INDs with political links</th>
</tr>
</thead>
<tbody>
<tr>
<td>Construction</td>
<td>5</td>
<td>2.50%</td>
<td>19.58</td>
<td></td>
<td></td>
<td>0.60</td>
</tr>
<tr>
<td>Consumer</td>
<td>31</td>
<td>15.50%</td>
<td>17.51</td>
<td></td>
<td></td>
<td>1.13</td>
</tr>
<tr>
<td>Trade and Services</td>
<td>42</td>
<td>21.00%</td>
<td>14.59</td>
<td></td>
<td></td>
<td>0.90</td>
</tr>
<tr>
<td>Industrial Products</td>
<td>83</td>
<td>41.50%</td>
<td>70.40</td>
<td></td>
<td></td>
<td>0.84</td>
</tr>
<tr>
<td>Infrastructure Project</td>
<td>1</td>
<td>0.50%</td>
<td>58.15</td>
<td></td>
<td></td>
<td>3.00</td>
</tr>
<tr>
<td>Plantation</td>
<td>7</td>
<td>3.50%</td>
<td>30.09</td>
<td></td>
<td></td>
<td>1.14</td>
</tr>
<tr>
<td>Properties</td>
<td>23</td>
<td>11.50%</td>
<td>65.82</td>
<td></td>
<td></td>
<td>0.96</td>
</tr>
<tr>
<td>Technology</td>
<td>8</td>
<td>4.00%</td>
<td>19.58</td>
<td></td>
<td></td>
<td>0.25</td>
</tr>
</tbody>
</table>
Total 200 100% 10.00 79.83 37.69 14.71 0.91
% % % % % %

Notes: Family ownership concentration is measured by family’s direct and indirect ownership in the company. No. of INDs with political links is measured by number of independent directors with current or former positions in the government or the ruling political parties.

Structural model parameters (shown in Figure 1) are estimated by partial least squares structural equation modeling (PLS-SEM) and using bootstrapping with 5000 samples (Hair, Hult, Ringle, & Sarstedt, 2013). The results are reported in Table 2. As it is shown, this research could not find any significant total effect in the model at 95% confidence level. It means; the effect of family ownership concentration on financial performance proxies including ROA ($\beta = 0.109$, $t$-value = 1.454) and ROE ($\beta = 0.088$, $t$-value = 1.140) without the presence of the mediator is not significant at 95% confidence level. Thus, the first hypothesis is not supported.

FIGURE 1: STRUCTURAL MODEL

TABLE 2. STRUCTURAL MODEL ASSESSMENT

<table>
<thead>
<tr>
<th>Outcome [← Mediator] ← Independent Variable</th>
<th>Path Coefficient ($t$-value)</th>
<th>Percentile 95% confidence intervals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Effects</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ROA ($R^2 = 12.94%$, $Q^2 = 12.91%$)</td>
<td>$0.109^{*}$ ($1.454$)</td>
<td>[-0.014; 0.232]</td>
</tr>
<tr>
<td>ROE ($R^2 = 5.56%$, $Q^2 = 5.99%$)</td>
<td>$0.088^{*}$ ($1.140$)</td>
<td>[-0.039; 0.215]</td>
</tr>
<tr>
<td>← Family ownership concentration</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direct Effects</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ROA</td>
<td>$0.094^{*}$ ($1.296$)</td>
<td>[-0.025; 0.213]</td>
</tr>
<tr>
<td>ROE</td>
<td>$0.072^{*}$ ($0.964$)</td>
<td>[-0.051; 0.196]</td>
</tr>
<tr>
<td>No. of INDs with political links</td>
<td>$0.143^{*}$ ($2.138$)</td>
<td>[0.033; 0.252]</td>
</tr>
<tr>
<td>← Family ownership concentration</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>ROA</td>
<td>ROE</td>
</tr>
<tr>
<td>----------------</td>
<td>-----------------------</td>
<td>-----------------------</td>
</tr>
<tr>
<td><strong>H3</strong></td>
<td>0.212(^*)(2.78)</td>
<td>0.220(^***)(3.26)</td>
</tr>
<tr>
<td><strong>H4</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

\(R^2 = 9.48\%, Q^2 = 10.52\%\)

<table>
<thead>
<tr>
<th></th>
<th>ROA</th>
<th>ROE</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>No. of INDs with political links</strong></td>
<td>-0.023(^***)(0.346) [0.086; 0.131]</td>
<td>-0.049(^***)(0.817) [0.049; 0.147]</td>
</tr>
<tr>
<td><strong>Industry</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>0.115(^***)(1.475)</td>
<td>0.254(^***)(4.16)</td>
</tr>
<tr>
<td><strong>Size</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Notes: Family ownership concentration is family’s direct and indirect ownership in the company. No. of INDs with political links is measured by number of independent directors with current or former positions in the government or the ruling political parties. ROA is return on assets measured by ratio of earnings before interest and taxes scaled by total assets. ROE is return on equity measured by ratio of earnings before interest and taxes to total equity of the company. Size is the natural logarithm of total assets of the company. Industry is the first two digits of the Standard Industrial Classification (SIC) code. SIC is a four-digit code which is developed for industry classification and the first two digits of the code address the major group of industries.

Financial performance of companies measured by ROA, ROE vary across different industries which is due to their different business operations, different level of expenditures, and different financing arrangements. In addition, the company size may affect financial performance of companies in different ways (Ghosh, 1998; Haniffa & Hudaib, 2006; Hannan & Freeman, 1989). Hence, this study controls for company size and industry type as if the effects of these factors are not controlled for, the effect of family ownership concentration and number of independent directors with political links on company financial performance may be spurious.

\*, **, and *** indicate statistical significance at the 0.05, 0.01, and 0.001 levels respectively. ns indicates not significant at 95% confidence level based on \(t(4999)\), one-tailed test: \(t(0.05, 4999) = 1.646, t(0.01, 4999) = 2.328, t(0.001, 4999) = 3.094\).

Then, the mediator is added to the model to test hypotheses addressing direct and mediation effects. The results show that the effect of higher family ownership concentration on number of independent directors having connections with the government and ruling political parties is significant at 95% confidence level (\(\beta = 0.143, t\)-value = 2.138) which supports the second hypothesis. Next, consistent with our third hypothesis, the effect of number of independent directors having connections with the government and ruling political parties on the performance of family-controlled publicly listed companies in Malaysia measured by ROA (\(\beta = 0.212, t\)-value = 2.788) and ROE (\(\beta = 0.220, t\)-value = 3.265) is significant as well.

Finally, by using bootstrapping approach (Hayes, 2009), the indirect effect of family ownership concentration on companies’ performance through appointing more independent directors with connections to the government and ruling political parties is significant for both performance proxies ROA (\(\beta = 0.030, t\)-value = 1.650) and ROE (\(\beta = 0.031, t\)-value = 1.786). As in this research the total effect of family ownership concentration on company
financial performance was not significant, the last findings can be reported as an indirect effect and the fourth hypothesis is supported partly. R-square of ROA and ROE indicates that 9.48% and 17.17% of these financial performance proxies are explained by the model. Besides, to assess predictive accuracy of the model, we use Stone-Geisser’s Q² (Geisser, 1975; Stone, 1974), implemented by blindfolding procedure in smartPLS 2.0. The results indicate that the model has appropriate predictive power for ROA (10.52%) and ROE (17.30%) (Henseler, Ringle, & Sinkovics, 2009).

CONCLUSION

Family-controlled, publicly-listed companies in Malaysia would exhibit a tendency to appoint independent directors who will not be involved in the day-to-day running of the company (Essen et al., 2012; Young et al., 2001). The avoidance of appointing outsiders to assume top executive posts is largely because of the importance of keeping decision-making power in the hands of the controlling family in these companies (Essen et al., 2012; Tsui-Auch, 2004; Young et al., 2001). However, this limits the board access to institutional environment such as the government which plays a key resource provision role in Malaysia.

Hence, in order to meet the Listing Requirements and the Code on Corporate Governance on the recommended proportions of independent directors on the board, as well as gain access to critical government resources in terms of contracts, licenses, soft loans, protection from competition, etc.; independent directors having close linkages with the government and ruling political parties, UMNO, are appointed on the board to provide such resources to enhance company performance. Consistent with this argument, the findings of this study show that publicly-listed companies with higher family ownership concentration do indeed appoint more independent directors who have strong connections with the government and ruling political parties and this enhances their financial performance. Much future research is needed on other resources that independent directors can provide to family-owned companies and their effect on company performance, leverage and risk.

ENDNOTES

1 UMNO is the largest and dominant political party and a founding member of the National Front coalition government in Malaysia

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Demographic Statistics Division, Malaysia, (2011) Demographic Transition in Malaysia.


