РАЗДЕЛ 3
КОРПОРАТИВНОЕ УПРАВЛЕНИЕ
В РАЗВИВАЮЩИХСЯ СТРАНАХ

SECTION 3
CORPORATE GOVERNANCE IN DEVELOPING COUNTRIES

INDEPENDENT DIRECTORS' RESOURCE PROVISION CAPABILITY IN PUBLICLY-LISTED COMPANIES IN MALAYSIA

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Abstract

We explore the notion that independent directors' primary role in developing capital markets is to act as key providers of distinctive resources and/or networks that are valuable to their respective firms. These resource provision capabilities become even more crucial in times of financial crisis. With a random sample of 289 companies listed on Bursa Malaysia, we test a set of hypotheses using paired sample *t*-test (for both pre-crisis (2007) and onset-of-crisis (2008) periods). Our results show that in times of crisis, companies exhibit a greater tendency to appoint more independent directors, especially those who (i) possess certain skills/resources that their firms specifically lack, and/or (ii) have strong political connections to secure government projects/funding/support.

Keywords: Resource Dependence Theory, Resource Provision Capability, Independent Directors, Malaysia, Global Credit Crisis

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1. Introduction

The 1997 Asian Financial Crisis exposed many significant flaws in various aspects of corporate governance at both company- and country-levels in developing countries across Asia (Kirkpatrick, 2009). As a consequence, extensive corporate governance reforms were carried out by many Asian economies. Most have modeled their reforms on codes and principles based around western ideals (especially the US and the UK).

Malaysia is no exception as the Malaysian Code on Corporate Governance draws extensively from the UK's Combined Code (Kean and Cheah, 2000). As with other Western-based codes, there is much emphasis placed upon the board of directors as one of the main mechanisms of effective governance. In effect, publicly-listed companies are compelled to ensure that their respective boards of directors have the right balance of executive and non-executive directors. Hence, particular attention has been devoted to increasing the proportion of independent non-executive directors on the board to ensure no group or individual can dominate decision making. The Listing Requirements of Bursa Malaysia stipulates that listed companies must have (i) at least two independent directors on the board, or (ii) at least one-third of directors on the board must be independent.

The Malaysian Code itself recommends employing independent directors on the board mainly to improve monitoring of the actions of top executives (Helland and Sykuta, 2005; Ryan and Wiggins, 2004). The underlying assumption is that outside independent directors are not beholden to management and, therefore, they can monitor executives more effectively on behalf of shareholders (Roy, 2011; Dunn and Sainty, 2009). If such assumptions hold, it is expected that by increasing the number of independent directors on the board, overall company performance would improve (Jackling and Johl, 2009; Baysinger and Butler, 1985; Hill and Snell, 1988; Schellenger *et al.*, 1989; Pearce and Zahra, 1992). However, findings of previous empirical studies on the relationship between independent directors and company performance in Malaysia are mixed (Ibrahim and Samad, 2011; Amran and Ahmad, 2009; Abdullah, 2004; Haniffa and Hudaib, 2006; Amran and Ahmad, 2010; Che Haat *et al.*, 2008).

We argue that the contradictory empirical findings reported are unsurprising as, unlike publicly-listed companies in the US and the UK, their Malaysian counterparts exhibit characteristics that are more typical of companies in developing countries such as highly concentrated ownership structures, a relationship-based business culture and extensive political involvement in business (Essen *et al.*, 2012; Claessens *et al.*, 2000; Mohd Ghazali, 2010; Rahman and Salim, 2010). In addition, the prevailing corporate culture in Malaysia is characterized by high collectivism, emphasis on harmonious relationships and high power distance (Jogulu and Ferkins, 2012; Hofstede and Hofstede, 2005; Hofstede, 1980). In effect, independent directors in such a cultural setting may likely avoid conflicts and robust exchanges/debates with top management, most of whom are also the majority owners of such entities (Kennedy, 2002; Jogulu, 2010). Put simply, Western principles-based conception of independent directors acting as monitors of top management may not be realistic. Indeed, some studies have found that key corporate decisions and decision-makers are rarely questioned and/or challenged under such conditions (Jogulu and Ferkins, 2012).

From the academic perspective, past empirical findings are therefore largely unsupportive of the executive monitoring-focused predictions arising from the dominant agency theory perspective. Although independent directors are unlikely to be effective outside monitors of company management, we argue that this does not diminish their importance. On the contrary, considering the distinctive nature/characteristics of corporate governance in developing capital markets, independent directors' primary role may instead be to provide and/or secure key resources that impact the performance and also success of the companies that they serve (Haniffa and Hudaib, 2006; Ibrahim and Samad, 2011; Hillman and Dalziel, 2003; Pfeffer and Salancik, 1978). This contention is highly consistent with the focus and also predictions of the resource dependence perspective literature. More specifically, in terms of resource provision capability, independent directors can provide strategic resources (such as technology and business know-how) as well as relational resources (including business networks and links to powerful politicians who can facilitate their access to contracts, projects, licenses, and loans) (Bammens *et al.*, 2011; Chen *et al.*, 2009; Essen *et al.*, 2012; Tsui-Auch, 2004; Young *et al.*, 2001).

In summary, we contend that the resource dependence perspective would yield interesting new insights pertaining to the distinctive role that independent directors play besides the often touted monitoring function in publicly-listed companies in Malaysia. We, therefore, provide a detailed elaboration of the resource dependence perspective in the next section.

2. Resource Dependence Theory

According to the resource dependence perspective (Selznick, 1949), companies continually act to reduce environmental uncertainty and dependency (Pfeffer and Salancik, 1978; Hillman *et al.*, 2009; Bryant and Davis, 2012). This can be achieved by reconfiguring internal structures to match environmental demands (Lawrence and Lorsch, 1967). In this sense, independent directors are regarded important not for their monitoring of top management function but for their ability to provide and/or secure important resources for their respective companies. This is especially true for resources that cannot be substituted easily which can include, and not limited to, expertise, information, contacts, networks, etc. (Gales and Kesner, 1994). Provision of distinctive resources serves to reduce organizational risk, uncertainty and enhance performance. Examples include securing large government projects by making use of close links to powerful politicians, securing the supplies of key components and commodities to reduce uncertainties in the production of goods, etc.

Expanding on the arguments above, some academics have contended that when companies need higher levels of external resources, they will increase board of directors' size with larger proportion of outside directors (Pfeffer, 1972). The composition of companies' boards of directors can therefore be viewed as a response to the external resource dependencies/ deficiencies faced. Put simply, "board size and composition are not random or independent factors, but are, rather, rational organizational responses to the conditions of the external environment" (Pfeffer, 1972, p. 226). As a consequence, Zahra and Pearce (1989) suggest that researchers should examine board attributes in companies at different stages of their respective life cycle to study the effect of environmental and organizational determinants on the composition of the company board.

Similarly, Hillman *et al.* (2000) empirically scrutinize the effects of deregulation in the US airline industry (as a significant external environmental change) on the composition of the boards of airline companies. Interestingly, they found that board replacements during the regulated period were more from insiders; however, post-deregulation, board replacements were more from outsider business expert and influential community pressure groups. Their study clearly shows that board composition changes in response to companies' specific needs for particular resources. Another study in the resource dependence tradition by Marlin and Geiger (2012) find that board characteristics differ across different industries - characteristics such as board size depend on type of industry and also the kinds of resources required by companies within a certain industry for their operations. Instead of just board size per se, Peng (2004) argued that boards with "more resource-rich outside directors" can increase access to needed resources and it improves the company performance. Hence, the number of outside directors or board members is not the matter, but the directors' type should be the focus of empirical scrutiny (Hillman *et al.*, 2009).

Consistent with the arguments put forth, our study contends that independent directors' (of publicly-listed companies in Malaysia) primary role is to act as resource providers. This is deemed appropriate as Malaysia's corporate sector exhibits characteristics that are typical of developing economies such as highly concentrated ownership, a relationship-based business culture, extensive political involvement in business, etc.

In addition, when companies face external uncertainty, new independent directors would be appointed to facilitate access to particular resources needed to mitigate external dependencies. Under such conditions, we argue that the resource provision role of independent directors merits more academic scrutiny. We test this proposition by making use of the 2008 global financial crisis period because independent directors' role will be more salient in such periods of uncertainty (Francis, Hasan and Wu, 2012). In effect, we study the characteristics of independent directors before and after the crisis to uncover how publicly listed companies in Malaysia utilize such a mechanism to access and/or secure valuable resources.

3. Hypothesis Development

From the resource dependence perspective (Pfeffer, 1972; Hillman *et al.*, 2000), independent directors of publicly-listed companies in Malaysia are likely to play a significant role in the provision and also securing of key resources that their companies require for good performance (Haniffa and Hudaib, 2006; Ibrahim and Samad, 2011; Pfeffer and Salancik, 1978). This is because independent directors are assumed to have significant networks that extend beyond inside directors' circles and this is crucial in accessing new resources, networks, connections and channels.

Our first prediction is that, in order to reduce external uncertainties, publicly-listed companies in Malaysia would generally prefer to appoint independent directors who will not be involved in the day-to-day running of such businesses (Young *et al.*, 2001; Essen *et al.*, 2012). The avoidance of appointing outsiders to assume top executive posts are largely a consequence of highly concentrated family ownership in most of these companies (Claessens *et al.*, 2000; Mohd Ghazali, 2010; Rahman and Salim, 2010). Specifically, in order to retain decision-making powers in the hands of the controlling family (Young *et al.*, 2001; Tsui-Auch, 2004), executive directors comprise almost exclusively of family members and close friends. Hence, in order to (i) satisfy the Listing Requirements as well as the Code on Corporate Governance on the recommended proportions of independent directors, and (ii) gain access to valuable external resources such as government contracts, rare commodities, specialized skills and expertise, etc; outside directors are appointed based on such provision capabilities.

The provision capabilities mentioned above becomes much more salient in times of crises, when abrupt changes in the external environment demand swift responses from these companies. Since any radical changes in the insider directors' composition can be interpreted as ineffectiveness of the current board in the running of these companies (i.e. send out negative signals to the market), publicly listed companies in Malaysia would prefer to change their independent directors' composition instead – primarily by appointing more independent directors within a short span of time which, in turn, increases the overall size of the board. This also serves as an indication of the companies' shift in focus to managing external risks. Changing the respective compositions of their boards' outside directors is also more preferable as compared to changing executive directors so as to avoid creating internal uncertainties as well. Therefore

H1a: The typical size of the boards of publicly listed companies in Malaysia increases significantly after the onset of crisis

H1b: Number of independent directors on the boards of publicly listed companies in Malaysia increases significantly after the onset of crisis

H1c: The proportion of independent directors on the boards of publicly listed companies in Malaysia increases significantly after the onset of crisis

Moving on, Hillman *et al.* (2000) suggest that each independent director possesses some unique attributes which fairly reflect the kinds of distinctive resources that he/she can provide to his/her company. Indeed, Peng (2004) placed great emphasis on independent directors' attributes and characteristics in determining their ability in providing certain sought-after resources. In this regard, our study investigates the distinctive resource provision capability of independent directors by making use of five specific indicators. They are as follows:

Bankers

In the times of crisis, banks experience the need to rebalance their portfolio to try to reduce incidences of non-performing loans and outright defaults. Therefore, they evaluate current and also potential borrowers in a highly stringent manner, often resulting in unwillingness to extend loan facilities and/or rejection of new loan applications. From the perspective of companies, access to financial capital would be significantly more difficult. Borrower companies' operations and even their survival are in question specially if they do not have any alternative sources of financing and are heavily dependent on the bank borrowings (Kaminsky and Reinhart, 2001). Hence, during the crisis, the presence of bankers and insurance company representatives as independent directors on the board may provide and facilitate companies' access to greatly sought after resources such as insurance, banking, and financial capital (Hillman *et al.*, 2000; Baysinger and Zardkoohi, 1986). Hence

H3: Publicly listed companies in Malaysia have more bankers as independent directors on their boards after the onset of crisis.

Government Servants and Politicians

In most developing countries around the world, large companies often reap benefits arising from close relationship with government leaders, officials, and/or politicians. Such benefits include obtaining "not only protection from foreign competition, but also concessions, licenses, monopoly rights, and government subsidies (usually in terms of low-interest loans from government financial institutions)" (Yoshihara, 1988: 3-4, 71 cited in Gomez and Jomo, 1999, p. 25). The aforementioned preferential treatment of certain companies by their respective national governments is often referred to as 'crony capitalism' (Yoshihara, 1988). Crony capitalism encourages rent-seeking behavior on the part of the companies as they do not have to increase efficiency nor productivity in order to prosper.

In Malaysia, rent seeking corporate activities became an integral part of the corporate landscape since the New Economic Policy (NEP) era in the 1970s (White, 2004; Gomez and Jomo, 1999; Johnson and Mitton, 2003). This is due to systematic and persistent government intervention in attempting to correct the economic imbalances between the country's main ethnic groups. In fact, Searle (1999) argued that no other Asian government has more extensive and intricate involvement in the corporate sector as Malaysia's (for instance, many of the largest publicly-listed companies in Malaysia are majority-owned by the govt). In effect, the enmeshing and blurring of the boundaries between business, politics and the state in Malaysia have profound implications for Malaysian capitalism and also corporate governance.

In terms of our study, therefore, we argue that having close relationship with the government and the ruling political parties can facilitate access to/secure licenses, governmental projects and contracts, monopoly rights, soft loans, and regulatory protection from competition, etc. (Essen *et al.*, 2012; Yoshihara, 1988; Li *et al.*, 2008). Indeed, some government leaders and politicians used the government's access to economic resources to support individuals and groups in return for backing of their political parties. It is therefore plausible that when companies' survival is threatened in times of crisis, they would expand their networks by appointing new independent directors with very close government or political party links in order to reduce external uncertainties. These companies may be bailed out or given benefits that are mentioned earlier (for instance, securing of major projects and exclusive licenses) probably in return for the company's future support. Hence

H4: Publicly listed companies in Malaysia have more government servants and politicians as independent directors on their boards after the onset of crisis.

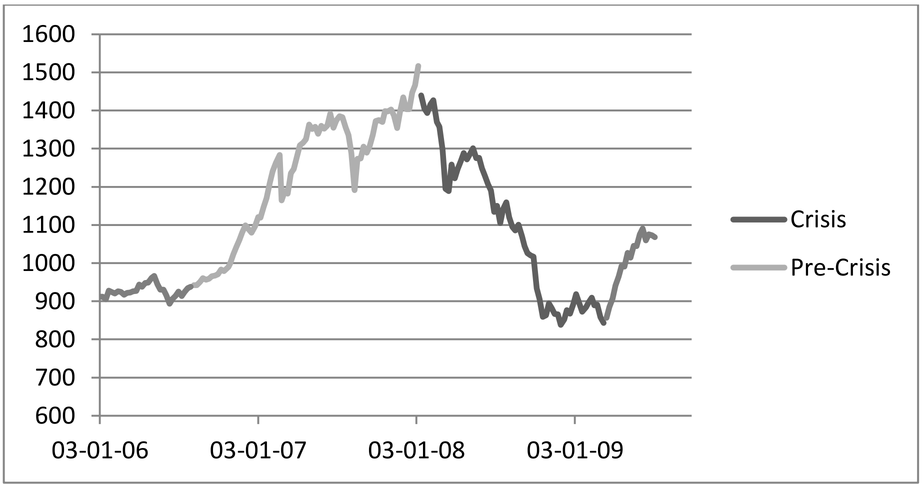
4. Sample Selection, Analysis and Discussion

4.1 Sample Selection

Our initial sample consists of 363 companies that are randomly selected from a total of 817 companies listed on Bursa Malaysia. Out of the 363 companies, 47 were excluded as they were listed after 2007 (i.e. post crisis period). Due to the distinctly different financial structures and policies of banks and financial institutions, we then removed 27 such companies from the sample. Our final sample, therefore, consists of 289 companies. The sample size satisfies the minimum of 262 companies as determined through the Krejcie and Morgan (1970) approach.

Subsequently, we collected data relating to the chosen companies' overall board size and number of independent directors. Subsequently, for each independent director, we collected data on a number of variables relating to independent directors' resource provision capabilities through content analysis of the chosen companies' annual reports. These reports were downloaded from chosen companies' websites or the Bursa Malaysia website for 2007 (pre-crisis period) and 2008 (crisis period). The pre-crisis and the crisis periods are determined by the KLCI index as it is shown in Figure 1.

Figure 1. KLCI, Pre-crisis and Crisis Periods



5. Analysis and Discussion

Table 1 shows that 34.9% of companies in the sample is in the industrial products sector following by 19.7% and 18.3% in the trade and services and consumer products sectors respectively. This finding indicates that broad sections of the market are relatively well-represented in our main sample. Next, Table 2.a shows descriptive statistics of board of directors' composition and also independent directors' characteristics (i.e. their resource provision capabilities).

Table 1. Samples across Sectors

	Number of Companies	Percent
Construction	10	3.5
Consumer	53	18.3
Hotels	3	1.0
Industrial Products	101	34.9
Infrastructure Project Companies	3	1.0
Plantation	14	4.8
Properties	35	12.1
Technology	13	4.5
Trade and Services	57	19.7
Total	289	100.0

To compare each characteristic between the pre-crisis (2007) and the onset of crisis (2008) periods, these hypotheses are tested by employing the paired sample *t*-test statistics with bootstrapping procedure with 2000 replications with replacement (Table 2.b) (Moore and McCabe, 2006). The results are shown in Table 2.b. The bias value of the statistics is the difference between the mean of the bootstrap distribution and the value of the original sample statistic and as it is shown, for each paired, it is close to zero.

Table 2.a. Board of Directors and Independent Directors' Characteristics

	Minimum	Maximum	Mean	Std. Deviation	Skewness	Kurtosis
Board Size, 2008	4.00	17.00	7.76	1.98	0.88	1.47
Board Size, 2007	3.00	17.00	7.47	2.01	0.93	1.77
Number of INDs, 2008	2.00	7.00	3.31	0.99	0.85	0.91
Number of INDs, 2007	2.00	7.00	3.11	1.00	0.98	0.91
Board Independency, 2008	0.22	0.83	0.43	0.11	0.93	0.87
Board Independency, 2007	0.22	0.75	0.42	0.11	0.97	0.66
Number of Bankers as INDs, 2008	0.00	2.00	0.26	0.50	1.76	2.26
Number of Bankers as INDs, 2007	0.00	2.00	0.24	0.47	1.81	2.45
Number of INDs with GOV Positions and Politicians, 2008	0.00	5.00	1.04	1.00	1.03	1.00
Number of INDs with GOV Positions and Politicians, 2007	0.00	5.00	0.97	0.97	1.12	1.42

Table 2.b. Paired Sample *t*-Test Bootstrapping Results for Comparing Board and Independent Directors' Characteristics during the Pre- and the Crisis Periods

The difference in the pre-crisis and crisis periods	Mean Difference	Bootstrap				
		Bias	Std. Error	p-value	Bias Corrected accelerated (BCa) 95% Confidence Interval	
					Lower	Upper
Board Size	0.28	0.0004	0.047	0.000	0.197	0.374
Number of INDs	0.20	0.0000	0.032	0.000	0.138	0.256
Board Independency	0.01	0.0002	0.004	0.003	0.005	0.020
Number of Bankers as INDs	0.02	0.0002	0.015	0.170	-0.007	0.052
Number of INDs with GOV Positions and Politicians	0.07	-0.0004	0.021	0.003	0.024	0.107

Board size is measured by number of directors on the board. Number of INDs is number of independent directors on the board. Board Independency is the ratio of independent directors to board size. Number of Bankers as INDs is number of bankers and insurance representatives as independent directors on the board. Number of INDs with GOV Positions and Politicians is number of independent directors with positions in the government or political parties.

The results in Table 2 show that publicly listed companies in Malaysia had larger board size after the onset of the crisis (M = 7.76, SD = 1.98) as compared to the pre-crisis period (M = 7.47, SD = 2.01), $p < 0.001$. The first hypothesis (H1a) is therefore supported. Even so, a bigger board size may point towards an increase in either (i) the number of independent directors, (ii) executive directors or (iii) a combination of both independent and executive directors. In this regard, hypotheses H1b and H1c have, in combination, shown that the increase is largely due to additional independent directors being appointed onto boards after the onset of the crisis. On the other hand, the number of executive directors remains mostly unchanged. More specifically, our findings show that number of independent directors after the onset of the crisis (M = 3.31, SD = 0.99) is significantly greater than before (M = 3.11, SD = 1.00), $p < 0.001$. Board independency of publicly-listed companies after the onset of the crisis (M = 0.43, SD = 0.11) is also significantly greater than before the crisis (M = 0.42, SD = 0.11), $p = 0.003$.

The findings above are supportive of the resource dependent perspective (Pfeffer, 1972; Pfeffer and Salancik; 1978, Hillman *et al.*; 2009;

Bryant and Davis, 2012) where board size expansion through appointment of independent directors reflects companies' need for higher levels of external resources due to increasing environmental uncertainties. Conversely, the replacement and/or appointment of executive directors are mostly avoided for a number of reasons. These include (i) the retention of decision-making powers in the hands of the controlling families, (ii) preservation of harmonious relationships between the close-knit executive directors, (iii) to prevent sending out negative signals to the market regarding executives' managerial acumen, and (iv) appointing more insiders who presumably are from the same network would likely not result in enhanced access to new, distinctive resources that are valuable to the firm. In short, companies appoint new directors onto their respective boards as a way of reducing their dependency for certain scarce/valuable resources. The uncertainty and dependency can be reduced by the specific resources that these directors would provide.

Next, we found that number of bankers being appointed as independent directors on the board in the pre-crisis (M = 0.24, SD = 0.47) and the onset of crisis (M = 0.26, SD = 0.50) periods is not significantly different, p = 0.17 and the third hypothesis is not supported. This indicates that publicly listed companies have not changed number of independent director bankers on their boards after the crisis. Indeed, concentrated ownership in forms of family ownership and government-linked companies are norm in publicly listed companies in Malaysia. Government-linked companies are under the government's support.

One possible explanation is that during the time periods considered in our study, the Malaysian finance industry was becoming more competitive and efficient and there is less probability that access to financial resources depends on banks representatives on the boards of companies. In fact, access to capital market resources and transactions more depends on long-term relationships with banks and financial institutions than "who you know" (Hillman *et al.*, 2000). At the same time, as companies are aware that during the crisis, banks limit their loan facilities, they shift their attention to government support to thrive and/or survive. Therefore, although after the crisis, publicly listed companies experienced a reduction in their profit margins, which is one of the determinants of access to financial resources, they do not see the need to appoint new bankers as independent directors on their boards. This finding does not indicate that publicly listed companies do not need any banker on their boards but merely it shows that after the crisis companies do not experience an increased need for bankers and financial institution members as their independent directors on their boards. Put simply, this is not an aspect that is seen to be a pressing resource deficiency.

The last set of findings show that publicly listed companies have more independent directors with current and former positions in the government and ruling political parties in the time of the crisis (M = 1.04, SD = 1.00) than before (M = 0.97, SD = 0.97), p = 0.003. This supports the fourth hypothesis. This finding can be explained by the rent-seeking relationship between businesses and the government which is described as 'crony capitalism' (Yoshihara, 1988). This relationship grew under the New Economic Policy (NEP) in Malaysia in 1970s and by growing public sector and regulations it became stronger (White, 2004; Gomez and Jomo, 1999). Besides, in the crisis time, the government resources become more critical as banks are reluctant to provide financial resources to companies (Kaminsky and Reinhart, 2001).

6. Conclusion

Due to highly concentrated ownership structures and also a corporate culture that is largely based around relationships in Malaysia, we contend that the primary role of independent directors in Malaysian publicly-listed companies is to provide key resources to the companies that they serve. These directors' resource provision capability becomes more even more salient in times of financial crisis. Indeed, under such a circumstance, companies typically use independent directors as a mechanism to reduce external uncertainties and dependencies. Thus, when publicly-listed companies face a crisis as an abrupt change in the environment, they appoint new independent directors who are capable to provide valuable resources, especially in areas where there are perceived deficiencies.

This research scrutinize two aspects of resource provision capability of independent directors - by number of bankers and number of government servants and politicians who serve such a role in Malaysian publicly-listed companies. Our results are supportive of this line of argument. More specifically, when companies experience crisis conditions, they exhibit a tendency to expand their boards by appointing new independent directors. In particular, appointments were made to increase these companies' links/channels/access to the government and powerful politicians in order to be accorded preferential treatment as predicted by the resource dependence perspective. In effect, such networks can facilitate their access to government contracts, soft loans, projects, etc.

Thus, while the results of previous empirical research in classical agency tradition have yielded conflicting results in attempts to explain independent directors' roles in developing countries, the resource dependence theory may provide more plausible explanation considering the governance characteristics of these economies. In short, we suggest that the resource dependence perspective offers a promising and potentially fruitful path to gaining new insights on independent directors' role in these markets. In this regard, much future research is needed on other aspects of resource provision capabilities of independent directors. Moreover, the effect of resource provision capability of independent directors on companies' performance can be examined. Furthermore, as in Malaysia family ownership and government-linked companies are norm, researchers can study how companies with different ownership types appoint independent directors to access to their required resources.

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