The Appointment of Directors and Corporate Governance in Malaysian Firms

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ABSTRACT

Corporate governance in many Asian nations is characterized by close-knit networks among market players. This paper examines the influence of major shareholders in the Malaysian largest publicly listed firms on the governance system of the firm. A survey among the largest listed firms in Malaysia is carried out to shed light on the influence of majority shareholder on directors' tenure and the association of directors to their firms. Concentrated ownership is found to be entrenched and directors have a close and intimate relationship with firm insiders. This has a serious implication on the implementation and enforcement of good corporate governance system and the development of labour market for professional directors.

Keywords:

Director appointment; Board of directors; Corporate governance

Introduction

Corporate governance covers a wide area of discipline and responsibilities among participants inside and outside of a firm; from owners, directors, managers to employees inside a firm, and from external auditors to market analysts outside of a firm (Fort and Schipani, 2003; Rubach, 1999). However, at the heart of the corporate governance are the issues of directing and controlling a firm (Cadbury, 1992). Rubach (1999: 7), echoing the same view, argued that corporate governance is largely shaped by “who controls the corporation, who makes the critical strategic decisions, who is responsible for those decisions, and who has claims against the revenues and assets of the firm.” These tasks are well connected to the roles of the board of directors. In fact, board of directors is a key player in the system of corporate governance given their strategic roles in drawing policies and strategies, implementing a governance system, and intensely interacting with management (Monks and Minow, 2000; Farrar, 2001; Bhagat, Carey and Elson, 1999; Prowse, 1994). Considering the strategic importance of board of directors, an understanding of their individual appointment and the dynamics involved is necessary for a proper level of control to be exerted across a firm. This paper focuses on a number of board practices that are significant to the discussion of controlling mechanisms and effective corporate governance, namely directors’ tenure and association with the firm as well as the appointment of directors.

Malaysian Corporate Sector

The contexts in which investors and firms operate affect their operational objectives and means of achieving their goals. In the Malaysian context, corporate control seems to be an attractive way in protecting one’s interests and to maximise his/her returns. Malaysia has been very proactive in endorsing good governance practices with an advance and comprehensive framework of corporate governance – The Malaysian Code on Corporate Governance (from here on referred to as the Code) – drawn promptly after 1997 Asian Crisis. The report indicates that good practices are expected to come from the “application of informed and independent judgement by experienced and qualified individuals – executive and non-executive directors, shareholders and auditors” (Commission, 2000, p. 5). This is a dilemma in a country lacking enforcement of investor protection. On one hand, corporate players are responsible to promote “best practice”; on the other hand, “best practice” is jeopardised when board of directors remains merely their mechanisms to control the firms. Nevertheless, large listed firms in Malaysia are keen on showing their efforts in adopting good governance structure, as evidenced in detailed report on corporate governance in their annual reports since year 2000.

However, the interpretation of “best practice” and other board practices varies from individual entrepreneur to another and from one firm to another.

Any discussion on corporate governance in Malaysia needs to take into account the New Economic Policy (NEP) 1971. The NEP 1971, together with the Industrial Co-ordination Act (ICA) 1975, requires all enterprises with equity over a specific limit to sell 30 percent of their shares to Bumiputera (Perkins and Woo, 1998). The policy specifically laid out the plan to attain 30 per cent in terms of corporate ownership and management for Bumiputera[1] by 1990 (Malaysia, 1971). As a result, massive governmental intervention in the corporate sector has begun. Besides heavily influencing the distribution of corporate wealth, the NEP has serious implications on other aspects of the Malaysian national economy. Torii (1997: 210) argues that the policy “partially restricts the full play of economic rationality as well as the market mechanism and equal opportunity principles in favour of Malay-first ethnicity principles coupled with political favouritism”. La Porta, Lopez-de-Silanes, Shleifer and Vishny (1998) have found that Malaysia’s relatively good protection of shareholders, originated from the legal family of common law, is lacking effective enforcement. The heavy governmental intervention might have impaired the enforcement of law and order in the corporate sector because ownership is distributed to rather than achieved competitively by certain groups of investors. Consequently, Bumiputera investors’ rights are shielded under the umbrella of NEP 1971 while Non-Bumiputera are left to strive for their own survival in any possible way, which include concentrating shareholding in their firms.

With the socio-economic policy overshadowing the development of Malaysian corporate sector and operating in an immature financial market with ineffective investor protection, many investors have employ ownership structure as a controlling mechanism to exert their control and protect their own interests in companies. A study by the Asian Development Bank reveals that the ownership structure

[1] According to Torri (1997), Bumiputera means “sons of the soil” in Bahasa Malaysia, the national language of Malaysia, which is equivalent to the original Malay language. Even though there is no legal definition associated with this term, “Bumiputera” effectively “distinguish Malays and indigenous peoples as the New Economic Policy (NEP) target groups from Chinese, Indians, and other immigrant population. See Torii, T. (1997) 'The New Economic Policy and the United Malays National Organization - With Special Reference to the Restructuring of Malaysian Society'. *The Developing Economies,* Vol. 35**,** No. 3, pp. 209-239.

in Malaysia is highly concentrated; the largest shareholder closely held 30.3 per cent of outstanding shares in an average public listed company while the top five collectively own 58.8 per cent on average (Zhuang, Edwards and Capulong, 2001; Abdul Samad, 2002). The nature of concentrated ownership in Malaysia serves as the backdrop in which we examine the issues of director appointment and association with listed companies in the country.

Appointment of Directors

A 1999 report by PricewaterhouseCoopers revealed that investors were very much concerned about the "quality and experience" of executive directors in Malaysia (PricewaterhouseCoopers, 1999). Their main concern was on the selection of directors. It has been well documented in the literature that the more competitive a labour market is, the lower the cost of hiring professional managers will be, given the transparency in contractual information between employer and employee which could prevent adverse selection and agency loss (Schulze, Lubatkin, Dino and Buchholtz, 2001). Failure in external labour market to a firm denotes that owners need to incur higher costs in selecting and monitoring the hired person; on the other hand, they could avoid these costs by self-managing their firms (Schulze *et al.*, 2001; Kangis and Kareklis, 2001).

The structure of concentrated ownership may instigate higher risk of adverse selection as monitoring effort is collected by a small group of insiders. However, ownership type mitigates the costs related to selection of directors through varying investment objectives and strategies. Researchers argued that internal labour market in individual controlled firms reduce costs of contracting executive directors because these directors are less tempted to move out of the firm due to their close personal link with the firm and/or large shareholders of the firm and disclosure of information between the two parties are more open (McConaughy, 2000; Ben-Porath, 1980). Therefore, this could also leads to longer tenure of directorship in these firms. It is important to note, though, that preferential contracts offered to an insider rather than to an outsider who is more qualified poses a risk of inferior performance in the long-run (Harvey, 1999).

Interestingly, the nomination, and subsequent election, of insider directors by individual large shareholders could be much more stringent than common expectations dictate, a phenomenon best explained by the factor of trustworthiness in the process of selection (Kao, 1996). The selection process is a tedious task over a long period of time where one will be monitored by the owner and works towards attaining the trust of the owner besides demonstrating his/her qualifications, knowledge, expertise and most importantly, loyalty (Kao, 1996; Chen, 1995; Tong, 1996). In this case, monitoring and control by owners over management and board of directors are achieved in an absolute rigorous manner. However, the reduction of agency costs could be compromised by loss in board diversity and freedom of open challenge.

This paper examines the extent to which directors are associated with insiders of a firm before they are appointed to the board. Furthermore, directors' entrenchment is also examined by looking at their tenure. An understanding of the selection process of directors in a market with dominating concentrated ownership structure offers important insights on the operation of Asia Pacific firms and the potential for developing professional directors in the future.

Methodologies

Sample and Procedure

A survey questionnaire was employed in this paper to identify the selection process of directors in Malaysian largest publicly listed firms. The sample used in this study was derived from the listed firms on the Kuala Lumpur Stock Exchange (KLSE). The 250 largest listed firms are selected based on their ranking of market capitalisation, and over 10 years of incorporation, where data is available in order to control for size and age. The selected firms together contribute to approximately 74% of the market capitalisation of all listed firms on KLSE in year 2000/2001.

A survey was conducted to provide any other pertinent information which are not readily available publicly (Norton, 1991). The instruments in the survey and the follow-up interview were drawn from various sources on the topics corporate control and corporate governance, which include the Code, other corporate governance frameworks and extant literature review (Exchange, 2001; Commission, 2000; Cadbury, 1992; Greenbury, 1995; Farrar, 2001). Rank vector was used where ranking was given to each item in an instrument, for example, 1 denotes the most important and n denotes the least important (Marden, 1995). Rank data format was employed rather than ordinal interval because the items in each instrument had to be mutually exclusive in order to examine how ownership type affected the priority of differing practices in corporate control, corporate governance and the selection of directors to the boards.

Response Rate

Since this study examined variables at the aggregate firm level, the individual company was the unit of analysis (Thompson, 2002). A total of 87 out of 250 companies had their surveys completed and returned, representing a 35% response rate. The low response rate might be due to the sensitivity of the subject/topic under examination (Harzing, 2000), since the survey enquired about the presence of large shareholders and their impact on corporate governance and board practices in the sample firms. Mailed survey has been associated with lower response rate as compared to personally distributed ones (Baruch, 1999). Furthermore, a very low response rate was typical in studies conducted in Southeast Asian countries given the fear of disclosing market intelligence and competitiveness somewhere in the process of the mail survey (Harzing, 2000).

Data Analysis

Univariate analysis was employed to investigate the level of ownership concentration according to different ownership types. For survey data, reliability test is not relevant in this study because respondents are required to rank items in a manner which the items are mutually exclusive of each other. A panel of experts comprising four practitioners of directorial and senior managerial levels in Malaysia and Singapore and four academics with extensive background knowledge in the areas of corporate governance and Asian business studies in Australia were consulted in order to provide content validity for the instruments (Creswell, 2003; de Vaus, 1990).

Results

Table 1 shows the distribution of companies that responded to the survey according to the types of largest shareholder and Bumiputera shareholders. Above half of the companies in the sample are closely held by Individual shareholders, approximately 57%, while among these companies, Almost 70% are closely held by Non-Bumiputera Individual shareholders. This is a reflection of the historical dominance of Non-Bumiputera, especially the Chinese, in the economic sector while Bumiputera are traditionally engaging in rural agricultural activities (Gomez and Jomo, 1997). Therefore, one could not deny the heavy influence of Confucianism in the business dealings in Malaysian corporate sector.

Table 1: Frequency Table for the Distribution of Companies According to Ownership Types.

Ownership Types	Frequency
Individual	56
State	9
Foreign	19
Trust Fun	14
Total	*98*
Non-Individual	45
Individual-Bumiputera	13
Individual-Non Bumiputera	39
Individual-Sino	1
Total	*98*

Table 2 suggests that there is a significant difference in the average tenure of directorship according to ownership type. Risk of entrenchment arise in INDIVIDUAL- and TF-firms where the average tenure is above 8 years (χ^2 [3, N=94] = 2.92, ρ < .05). This might be driven by the different operational perspectives and higher number of insider-executive directors in INDIVIDUAL businesses. High risk of entrenchment could possibly lead to higher agency costs, hence lower firm performance.

Table 2: ANOVA for Tenure of Directorship

Question 1: How long have you been a director in this company (years)?			
Ownership Types	Mean	ρ	N
Individual Firms	8.26	.038	95
State Firms	2.39		
Foreign Firms	5.44		
Trust Fund Firms	8.79		
Total	7.25		

Table 3 shows how a director is approached prior to his/her appointment. There is no significant difference between groups. The majority of the directors were approached by insiders of the firms, either by member of the Board of Directors or the largest shareholder. This finding indicates that business networking and contacts were very important in obtaining market intelligence and opportunities.

Table 3: Cross-tabulation for the Party who Approach a Director before Appointment

Question 2: Who approached you at first about your appointment as a director in this company?

Ownership Types	Board of Directors (Exclude Largest Shareholder)	Largest Shareholder	Third Party and others	**Total**	χ^2	*n*
Individual Firms	41.8	41.8	16.4	100.0	.990	98
State Firms	44.4	44.4	11.1	100.0		
Foreign Firms	50.0	38.9	11.1	100.0		
Trust Fund Firms	37.5	43.8	18.8	100.0		
Total	42.9	41.8	15.3	100.0		

Table 4 indicates the association between the directors and the firms. The first part of the result approached the 5% significance level. Approximately 40% of directors in INDIVIDUAL-firms are associated with an insider in the firm (χ^2 b = 7.05, ρ = .07). However, there is no difference in terms of who they are associated to. Majority of the respondents who have association with the firm is associated with the largest shareholder, an implication of the exertion of control by the largest shareholder.

Table 4: Cross-tabulation for Director's Association with Firm Insiders

Question 5: Are you associated (being a family member, relatives, long-term friend or close associates) with any shareholder, the Chairman, the CEO, or other directors in this company?

Ownership Types	Yes	No	**Total**	χ^2	*n*
Individual Firms	40.0	60.0	100.0	.070	98
State Firms	11.1	88.9	100.0		
Foreign Firms	22.2	77.8	100.0		
Trust Fund Firms	12.5	87.5	100.0		
Total	29.6	70.4	100.0		

Ownership Types	Largest Share-holder	Minority Share-holder	Chairman (Exclude Largest Shareholder)	Non-Executive Director (Exclude Largest Shareholder)	**Total**	χ^2	*n*
Individual Firms	76.2	9.5	9.5	4.8	100.0	.260	28
State Firms	100.0	0.0	0.0	0.0	100.0		

Foreign Firms	50.0	0.0	50.0	0.0	100.0
Trust Fund Firms	50.0	0.0	0.0	50.0	100.0
Total	71.4	7.1	14.3	7.1	100.0

Discussion

This paper examines the selection process of directors in Malaysian largest firms and its implications on the development of corporate governance in Malaysia and the Asian region. We found that selection and appointment of directors in the sample firms were mainly done through the existing network between firm insiders, such as members of the current board of directors or largest shareholder, and the directors to be appointed. This finding confirmed earlier study by Westphal and Zajac (1997: 164) which found that "CEO-director network is an arena likely to be characterized by a generalized reciprocity among top managers and CEO-directors." Many directors fail to acknowledge their close association simply because there is an absence of blood relation between them and firm insiders, which the result shows that only 30% of directors recognise their association in the study, but this does not exclude the significance of heavily intertwined networks that are built upon long-term business dealings among parties. Tan and Tam (2004) found that businesses and politics are strongly intertwined in networks in Malaysia; and the their results show significant impact on firm performance. The presence of heavy networking and connection (*guanxi*) in the Malaysian corporate sector is not surprising given the dominating influence of Chinese entrepreneurs in the economic development of the country. Hofstede and Bond (1988) contended that the Chinese are typically characterized by high collectivism, among others. This orientation may well influence the appointment of directors in that people who are within the network circle of the current directors or dominant shareholders get selected into the position. That nepotism is involved in the selection and appointment of directors in Malaysia is highly likely since, according to findings from the Global Leadership and Organizational Behavior Effectiveness Study, Malaysia is distinguished as a country that ranks very high on the dimension of 'group and family collectivism' above all other dimensions (Gupta, Surie, Javidan, and Chhokar, 2002). Yeung and Tung (1996) contended that kinship, or members of a person' immediate and extended family, is a common base for *guanxi*, and that the Chinese typically would more readily offer help to them than they would to a friend.

With heavy networking comes adverse selection. In developing economies, adverse selection serves as an important background check on directors, as information is often highly reserved and guarded against outsiders (Tan, 2005). Large shareholders obtain higher level of security when they could know the background of the nominated director and anticipate their potential working relationship together since cost of information sharing is high. Moreover, with the close association, large shareholders could scrutinise and reserve the right to dispose of any incompetent directors. The long average tenure of directors also implies that the selection process is believed to be stringent, especially in firms controlled by individuals. This is shown by the result that, before their appointments, majority of directors are approached by members of board of directors and/or the largest shareholders in all firms. On the hand, adverse selection could bring entrenchment of directorship and violation of board independence since the appointed Independent directors would feel obligated to comply with the demand and decisions of the major personalities in control. Moreover, the tendency to select directors who have similar outlook may jeopardise the diversity of knowledge, expertise and experience of the board. For example, Gupta, Surie, Javidan, and Chhokar (2002) argued that the most fitting leadership styles for Malaysian businesses to maximize performance are transformational-charismatic and team-oriented leadership. This finding implies that Malaysian employees prefer leaders who are visionary, inspirational, and sacrificial on the one hand, and team-focused, tactful, and collaborative on the other hand. The least fitting leadership style in the Malaysian context is self-protective leaders, characterized as self-absorbed, face-saver, and bureaucratic.

Our findings offer important implications on the labour market of Malaysia. Given that the market for professional directors is relatively small and underdeveloped in the country, the close relationships offer insurance to employers in the quality and trustworthiness of a director. It is argued that failure in external labour market to a firm denotes that owners need to incur higher costs in selecting and monitoring the hired person (Schulze *et al.*, 2001; Kangis and Kareklis, 2001). In individual-firms, the existence of internal labour market decreases the costs of hiring executive directors because they are less likely to move out of the firm when they have personal link to the business and/or the largest shareholder, and this relationship contributes to higher information disclosure among themselves

(McConaughy, 2000; Ben-Porath, 1980). However, the advantage in cost saving may compromise the development of professional directors in the market. Less attention and demand will be paid to independent professional training of directorship. Instead, directors are expected to gain knowledge and expertise about their fiduciary duties through their experience and participation in firm and industry activities. This, in turn, results in varying understanding and practice of directorship. Hence, the existing corporate governance framework may not be exhaustive in governing their acts.

Conclusion

This paper examines the appointment of directors and the association of directors with firm insiders in Malaysia. Ownership data is drawn from the top 250 listed firms in Malaysia while a survey is conducted to gather primary data in other areas. The results show the appointment of directors is closely link to their relationships with firm insiders, such as the current members of the board of directors and the largest shareholders. About 30% of directors are associated with firm insiders and most are associated with the largest shareholder. Also, directors tenure is above eight years in Individual- and trust-fund-controlled companies, which shows a higher tendency for directors' entrenchment in institutional held companies.

Concentrated ownership is a prominent tool for investors to exert control over their firms. In addition, corporate control could be achieved through influencing the appointment of directors to the board. This shows the presence of adverse selection in Malaysia. This paper argues that adverse selection could bring advantages as well as disadvantages to firms, especially in developing economies. Serious attention should be paid to the definition of ultimate ownership and corporate control as investors of varying types operating in different context might be interested in exercising different level of control and hence, view controlling mechanisms differently. The goal in achieving corporate control, therefore, has tremendous impact on the labour market and professional development of directorships.

This study is limited in the examination on the types of association between directors and firm insiders in details. Furthermore, the inclusion of ownership concentration might also explain the level of association. Future research should address these issues in greater details.

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