Accounting, Organizations and Society 43 (2015) 67–86

Contents lists available at ScienceDirect

Accounting, Organizations and Society

journal homepage: www.elsevier.com/locate/aos

Corporate political connections and the 2008 Malaysian election

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ABSTRACT

We examine whether the relationship between political connections and firm value is moderated by the length of time firms have been politically connected. We find that compared to firms with political connections for a short period, firms with political connections for a long period have a smaller magnitude of negative stock price reaction to the 2008 General Election loss of the supermajority by the ruling party in Malaysia. We also find that the smaller magnitude of negative stock price reaction is, in part, attributable to improvements in board of director characteristics. Furthermore, we find that while the performance subsequent to the General Election of politically connected firms is worse than that of non-politically connected firms, firms with political connections for a long period exhibit better performance than those connected for short periods. Collectively, the evidence shows that the length of political connections is an important factor that moderates economic value.

Introduction

Prior research shows that firms' political connections are positively associated with firm value (Bliss & Gul, 2012; Boubakri, Guedhami, Mishra, & Saffar, 2012; Faccio, 2006; Fisman, 2001; Johnson & Mitton, 2003). Li and Zhang (2007) show how managers' functional experience and their political network help to enhance performance of new ventures (also see Lester, Hillman, Zardkoohi, & Cannella, 2008). A natural question that arises is whether political connections continue to be as important for firms during later periods as they are in initial periods. Accordingly, we examine the following two research questions: (a) Is the relationship between firms' political connection and firm value different for firms with political connections for longer and shorter periods? (b) What is the mechanism that drives the differential relationship?

We draw on institutional theory in sociology to develop the hypothesis that the relationship between political connections and firm value is moderated by the length of time over which firms are politically connected (see Rona-Tas, 1994). Specifically, we posit that compared to firms that are politically connected for a short period of time, firms that are politically connected for a long period of time are more likely to have built their credibility of adherence to government policies which allows them access to the informal political elite network (DiMaggio & Powell, 1983; Donaldson, 2008; Sanders & Tuschke, 2007). This in turn would enable them to obtain important economic resources such as talented managers and become more self-sustaining. Thus, we expect firms with political connections for a long period to be less severely affected by the loss of political power by the ruling party (in terms

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http://dx.doi.org/10.1016/j.aos.2015.04.001
0361-3682/

of their supermajority) than firms with political connections for a short period.

We examine this hypothesis in the 2008 Malaysian General Election setting where the ruling party – the National Front or Barisan Nasional (BN) – unexpectedly lost their longstanding supermajority. To identify politically connected firms, we update the list provided by Johnson and Mitton (2003) and Faccio, Masulis, and McConnell (2006). Firms that are identified as politically connected in both 1997/1998 and 2007 are classified as firms with political connections for a long period (referred to as old-politically connected firms); and firms that are politically connected only in 2007 are classified as firms with political connections for a short period (referred to as new-politically connected firms). In particular, we identify 122 politically connected firms out of which 39 are new-politically connected firms.

Consistent with our hypothesis, we find that the magnitude of negative stock market reaction to the ruling party's election loss of supermajority is less for the old-politically connected firms than the new-politically connected firms. To examine the mechanism through which the old-politically connected firms insulate themselves from the adverse consequences of the loss in supermajority power by the ruling party, we investigate the change in board of director characteristics and senior executive characteristics over ten years across old- and new-politically connected firms. We find that the old-politically connected firms become more professional than the new-politically connected firms. Interestingly, we find that changes in board professionalism exhibits improvement for old-politically connected firms over the ten years, but executive professionalism does not. Furthermore, we find that the negative stock price reaction to the election result is attenuated for those old-politically connected firms who show improvements in professionalism, and not for those who do not show such improvements. While, this evidence provides insight into the mechanism through which political connections enhance value, the access to managerial talent that old-politically connected firms develop can by itself help them to continue to extract rents even when the direct benefits of political connection are removed. As such, this evidence could be interpreted as a form of cronyism as well.

Lastly, we attempt to address whether the improvements in board professionalism could be related to cronyism, by examining the subsequent accounting and stock market performance. In particular, we consider return on assets and annual stock return for the three years subsequent to 2008 for the old- and new-politically connected firms. We find that compared to the non-politically connected firms, the accounting and stock market return performance are worse for both the old- and new-politically connected firms; but less so for the old-politically connected firms than the new-politically connected firms. This provides additional evidence that while old-politically connected firms are more self-sustaining than the new-politically connected firms, both of them exhibit worse performance than non-politically connected firms.

The remainder of the paper is organized as follows: First we provide the background literature and the research question; second, we describe the Malaysian context and the General Election in 2008, and develop the hypotheses; third, we present the empirical analysis; and finally, we provide some concluding remarks.

Background and hypotheses

Background and research question

The institutional view is based on the premise that organizations adopt structures in response to their institutional environments and hence is an important theoretical lens in international business (see Carpenter & Feroz, 2001; DiMaggio & Powell, 1983; North, 1990; Peng, Sun, Pinkham, & Chen, 2009; Peng, Wang, & Jiang, 2008; Wan & Hoskisson, 2003). Specifically, firms' operations and management practices are bound by formal and informal country-specific institutions (see Ingram & Silverman, 2002). The formal and informal institutions influence market competition (Khanna & Palepu, 1997; Peng, 2003; Porter, 1990), and firms' resource allocation decisions either directly (North, 1990; Wan & Hoskisson, 2003), or indirectly through management and corporate governance practices (Aguilera & Jackson, 2003; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000).[3]

Managers' ties with government officials, i.e., political connections represent a unique economic resource in transition economies (Li & Atuahene-Gima, 2001). Because the government controls significant portions of strategic resources and has considerable power to approve projects and allocate resources, managers tend to maintain a 'disproportionately greater contact' with government officials (Child, 1994). Empirically, Nee (1992) finds that managers' networking with local officials is associated with better performance of new ventures in China. Similarly, Peng and Luo (2000) show that the strength of ties between firms' managers and government officials is positively associated with firms' performance in China (also see, Li & Atuahene-Gima, 2002; Li & Zhang, 2007; Lu, 2000). Thus, political connections are an informal institution that provides direct benefits in the form of government favors and subsidies. The natural question that arises is whether political connections enable firms to become more or less self-sustaining in the long-run.[4] Accordingly, the objective of this study is to examine whether firms that are politically connected for a long period of time become more self-sustaining, i.e., insulated from the loss of direct benefits arising from such connections.

[3] Other studies have examined how firms and other market participants (such as financial analysts) respond to changing institutional conditions (for example see, Fogarty & Rogers, 2005; Greenwood & Hinings, 1996; Hoffman, 1999; Newman, 2000; Peng, 2003).

[4] Loosely speaking, the research question is similar to the question of whether children with privilege such as belonging to higher socio-economic strata turn out to be 'spoilt' or 'good citizens' of society; given that children in higher socio-economic strata have an advantage not only from obtaining direct benefits of extra favors resulting from their elite status, but also from obtaining education and developing networks that enables them to become more self-sustaining. Our question is whether politically connected firms are similar to spoilt-children or good citizens of society.