

FACTORS THAT INFLUENCE CORPORATE GOVERNANCE FAILURES IN MALAYSIA

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ABSTRACT

In this modern competitive world, corporate failure has been debated as it had an adverse effect on many people such as shareholders, employees, suppliers, and also gives a diverse impact on the local as well as international communities. This paper explores the impact and how to overcome corporate failure in Malaysia. The first part of the paper describes all the relevant facts about the company selected. In this section, will review the corporate scandal happen and factors that leads to corporate failure by using theory of fraud diamond. The second part of the paper explores the recommendation and challenges that are needed to address corporate failure. The recommendations include having the basic fundamentals of a good company culture such as integrity, transparency, accountability which starts from the tone at the top. Organizations need to also review their internal control systems such as strengthening their standard operating procedure and controls to ensure all weaknesses in controls are addressed. Organizations also need to strictly enforce the laws and regulations as well as implement on-going monitoring to ensure that all parties, internal and external comply with the laws and regulations set. Lastly, the paper will share the lessons learned from the two cases examined.

Keywords: Theory of the fraud triangle, corporate failure, integrity

INTRODUCTION

CEO of Mitsubishi Corporation, B. Minoru Makihara has once stressed that "As governments throughout the world reduce barriers to trade, and investors insist on being able to purchase securities in any company, regardless of its domicile, understanding and evaluating corporate governance systems is absolutely essential". (Monks and Minow, 2000).

In the Malaysian perspective, The Malaysian High Level Finance Committee on Corporate Governance (Finance Committee, 1999,p.52) defines the term corporate governance as "the process and structure used to direct and manage the business prosperity and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate

objective of realizing long-term shareholders value, whilst taking into account the interests of other stakeholders.” This definition that corporate governance is concerned with internal and also external controls. Then, Gatamah (2004) has stressed that corporate governance is focused with the social political as well as legal environment in which the organization operates, systems practices and procedures by the formal and informal rule. This issue stressed the significance of integrity, transparency and accountability while conduct the business.

This study was produced with regard to corporate governance failure issues. Nowadays, corporate governance has emerged as a global issue. The findings of a survey by McKinsey (2002) found that majority of investors would be prepared to pay a premium to invest with a company with good and effective corporate governance. The survey stressed that good corporate governance includes a majority of independent outside directors, significant director share ownership, formal director evaluation as well as quick response to shareholders’ requests. So, effective corporate governance are significance for the stability of economics, and socials. However, there have been a number of companies around the world that have collapsed because of corporate failure. One significant case is, Enron which used to be one of the successful companies that had collapse because of corporate failure issue. Another case is Parmalat, a successful foodstuff industry in Italy also collapsed in December 2013 because of poor corporate governance.

Malaysia has also experienced corporate governance cases such Perwaja Steel, Sime Darby and also the Malaysia Airlines. Some views that the reason corporate failure in Malaysia is because of the Asian Economic Crisis in 1997. Generally, effective corporate governance is determined by a number of factors which includes quality board of directors, quality audit committee, quality internal control system, effective of internal audit function, independent external audits as well as quality board of directors.

CORPORATE GOVERNANCE FAILURE

Many studies have explored the relationship between corporate governance and corporate performance. In contrast, only a few studies have looked at corporate governance and corporate failure. Even though interest in corporate governance has grown rapidly in recent years with the global increase in the number of corporate failures such as Enron, WorldCom, HealthSouth and Arthur Anderson; the role of corporate governance in corporate failure has been largely neglected (Lakshan and Wijekoon, 2012). The researchers also mention that it is because of lack of consistent policies, control procedures, guidelines and mechanisms to ensure accountability and fiduciary duty. Poor corporate governance can increase the probability of corporate failure even for firms with good financial performances. This paper summarizes two corporate failures in Malaysia and examines what could go wrong? What might be done to prevent such collapse from happening? And what are the effects of governance failure? There are three main objectives of the study. The first one is to analyze factors that contribute to corporate failure among companies in Malaysia. Fraud Diamond theory will be used as a basis of highlighting the causes that has led to the poor corporate governance failure. The paper will then end with the recommendations and lessons learned on how to overcome the corporate failure which can act as a guide for future cases.

PRIOR LITERATURE

According to International Monetary Fund (IMF, 1999), the ASEAN crisis was infected by the domestic policy weaknesses, including poor risk management. Poor risk management was reflected by weak corporate governance as the report on corporate governance (2002) states:

“Corporate governance is the process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realizing long term shareholder value, whilst taking account the interests of other stakeholders”.

The Malaysian Code on Corporate Governance (2000) requires that there is a balance of power and authority between Chairman and Chief Executive Officer so that no one individual has unfettered powers of decision. It is recommended that a strong independent element should be induced and publicly explained in the event of CEO duality. However, Donaldson and Davis (1991) and Brickley et al. (1997) argue that a joint leadership structure results in a more clear and transparent communication between management and the board of directors. This is basically based on the kind of industry that they are involved in. Different type of industry requires different leadership style.

In summary, there are many factors that trigger corporate governance failure. What is important is communication and ethics which Grunig (2001) indicates that responsiveness is consistent with both the two-way symmetrical views of corporate communication and the stakeholder model of organizational ethics. Over the year Malaysia has different prime minister, From Tun Dr Mahathir Mohamad era, next Tun Abdullah Ahmad Badawi and currently prime minister which is Dato’ Sri Najib Razak, Malaysia has improved and continues improvement the laws and also anti-corruption agency. Below are the diagram of the development of anti-corruption laws in Malaysia and the development of anti-corruption agency in Malaysia.

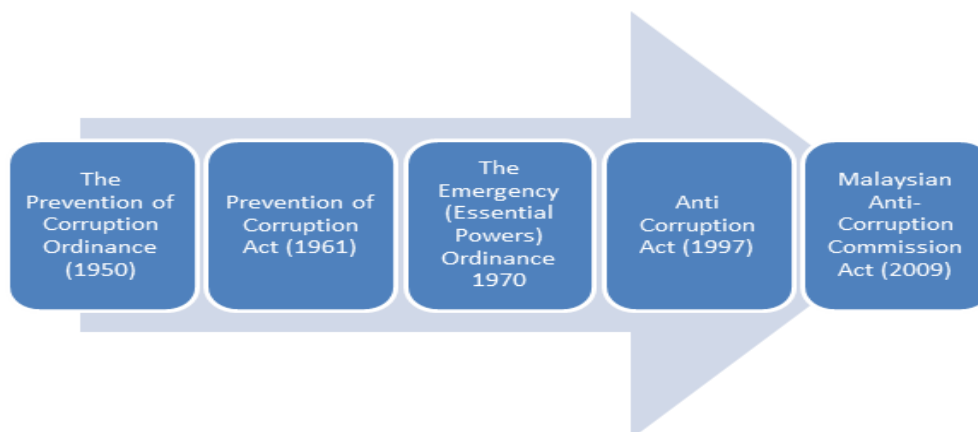


Figure 1: The development of anti-corruption laws in Malaysia

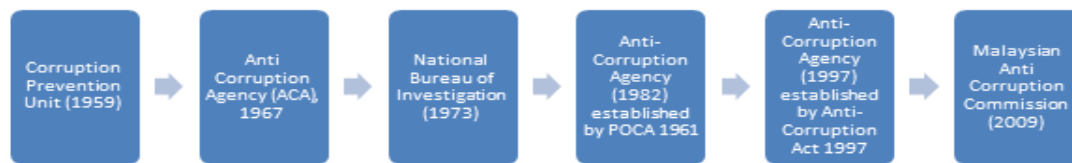


Figure 2: The development of anti-corruption agency in Malaysia (Yusoff et al., 2012)

GOOD CORPORATE GOVERNANCE

Recently, in one conference on integrity and governance organized by Women’s Institute of Management (WIM), Former Deputy Prime Minister, Tun Musa Hitam has stressed that a company’s directors and managers were practicing good corporate governance when they are ensured transparency as well as accountability in decision making, applied corporate social responsibility and at the same time cared about the shareholders. These are indeed essential elements if companies want to be run well. (“Corporate governance-a shared responsibility,”2016). Other than that, the honourable Prime Minister, Dato Seri Najib Tun Razak has set a general goal for 2050 National Transformation for Malaysia (TN50) to become a top 20 country in the world by the year 2050. For this purpose, the honourable Prime Minister has announced that government will create a creativity and innovation index as a reference to achieve TN50. (“TN50- journey to the top 20 begins today,” 2017). In addition to this, Dato Seri Najib Tun Razak added that this index is important to organisation, company as well as to nation so that it would be competitive.

The honourable Prime Minister, give an example of the situation of Nokia, which at one time was a big telephone company but now have been dominated by smartphones likes Apple, Samsung and Huawei. He stressed that this occur as the companies strategically adopt innovation to keep them competitive and relevant within the industry. Same goes to the government; public servants must deliver government service more efficiently and at the same and with integrity. (“TN50- journey to the top 20 begins today,” 2017). In summary, efficiency of the public service can be developed through good corporate governance and by having good corporate governance; it can help government to achieve vision 2020 and also TN50. There are three examples organisations that practices good corporate governance in Malaysia. Firstly, Perbadanan Kemajuan Negeri Selangor (PKNS) is one of the good example government agencies that have good corporate governance after the management committed to improve the standards operating policy and procedures. General Manager of PKNS, Noraida Mohd Yusof claimed that PKNS has not only managed to reduce its operating cost through good corporate governance but garnered many other assets. Besides that, PKNS has also achieved savings of 13 per cent through a more transparent and effective open tender system. Other than that, another alternative to promote good corporate governance by PKNS is the management have appointed an independent director to sit on their Board of Directors and three representatives from the Finance Ministry to monitor auditing issues. (“PKNS model of good corporate governance,” 2016). This is ensured the transparency as well as accountability of the organisation.

Other than that, DiGi.Com Berhad is one of the example good corporate governance. Digi known as company that conducting its business in accordance with the highest ethical standards and maintaining a workplace environment that encourages open and honest communication. DiGi has adopted the code of conduct, anti-corruption policy, no gift policy, suppliers’ code of conduct and HSSE policy. (Corporate Overview, Retrieved from www.digi.com.my).

Last but not least, Thumbprints Utd Sdn Bhd (TUSB) a company which specialized in print books, trade promotion materials, and cardboard packaging is the first Small Medium Enterprise (SME) Company implements its own Zero corruption Programme that explained in the company’s code of business ethics. Moreover, TUSB also the first SME practise Corporate Integrity Pledge (CIP) when it introduced by the Malaysian Anti-Corruption Commission (MACC) in 2011. Above all, TSB is one example company that practice good corporate governance in their operation and management. TSB implement ethical operation, management and production systems and at the same time the company has a strong commitment to training and product improvement. (NKRA E-Newsletter, April 2015) As a result, TUSB able to deliver high quality products on time and on budget which lead to increasingly competitive in global market. Suruhanjaya Syarikat Malaysia (SSM) has a Code of Ethics placed on their website which all company in Malaysia need to be practiced. In the performance of his duties, a director should at all times observe the following Code of Ethics for Company Directors which can refer in their website. (Code of Ethics for Company Directors, Retrieved from www.ssm.com.my).

CORPORATE GOVERNANCE ISSUES IN MALAYSIA

The corruption perception index (CPI) 2015 has ranked Malaysia number of 54 among 168 countries with a score of 50 out of 100. This is a drop from rank 50 out of 175 countries in CPI 2014 (Transparency.org). Due to that, Transparency International Malaysia (TI-M) President, Datuk Akhbar Satar has come out with several recommendations on how to improve the rankings. Among the suggestions are there is need for MACC to be independent so that it can perform its duties efficiently. Besides that, the government itself needs to eliminate the culture of secrecy and also established political funding laws. (“Malaysia ranked 54 among 168 countries in the Corruption Perception Index,” 2016). Generally, the CPI is an important indicator as the ranking describes on how corrupt the public sector of one country. The CPI ranking represents how much the country committed to eliminate unethical behavior likes fraud.

In addition to this, currently, Malaysia scored 5.16 points out of 7 on the 2016-2017 Global Competitiveness Report (GCR) published by the World Economic Forum. The GCR is an annual report that combines 114 indicators that integrate both macro and micro economic aspects of competitiveness. Furthermore, International Trade and Industry Minister, Y.B. Dato’ Sri Mustapa Mohamed, has stressed that external factors is the main reason Malaysia scored 5.16 compared to last year which scored 5.23. Among the external factors includes the global economic uncertainty, the strong US dollar, the fall in commodity prices as well as the slowdown in China’s economy. (“Malaysia’s global competitiveness ranking in line with economic slowdown,” 2016).

This paper also highlights two case studies in Malaysia, which are referred to as Company X and Company Y. The corporate governance failure was detected by the Malaysian Anti-Corruption Agency (MACC) and as a result the top management for both companies has been charged with corruption. As for these two companies, both have uncertainty in their financial statements. In addition, company X as well company Y also do not comply to the procedures regarding tendering and contract enforcement. Both leaders of companies X and Y have been reported to be involved in a grand corruption, which includes major abuse of power which has led to the breakdown of good corporate governance.

It was also stated that there is an element conflict of interest present in these two companies. As an example, in company Y the board of directors and chairman are also controlled by one family. As for company X, the director misuse the company money for their own interest. This also can be called as conflict of interest. Company X have been operated since 2006. Their companies are more to the contract farming which involving product marketing throughout Malaysia.

The occurrence of fraud in these two companies has given an adverse impact to the corporate governance standard in Malaysia. Hence, in the long term effect, this case can affect the confidence of foreign investments and at the same time affecting Malaysia economy.

THEORY OF FRAUD DIAMOND

Fraud diamond existed after fraud triangle which only added new one which is capabilities. Previously it has opportunity, pressure and also rationalization in fraud triangle. This happen because those three elements is not going to happen if the fraudster does not have capabilities to do fraud. As have been said by Wolfe and Hermanson (2004) that fraud will happen if the fourth element (capability) is also present as he or she must have the skills and ability to commit fraud. Below figure shows the fraud diamond which taken from Wolfe and Hermanson (2004).

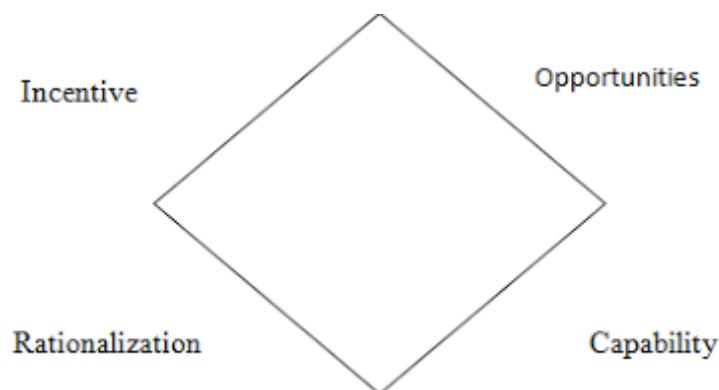


Figure 3: The fraud diamond (Wolfe and Hermanson, 2004)

Perceived Incentive/ Pressure/ Motive

Previous studies have different perspective on pressure. As Albrecht et al. (2008, 2010) divided pressure/motive into financial or non-financial. Murdock (2008) divided pressure into financial, non-financial, political and social. Rae and Subramaniam (2008) studied employees' motivation and financial pressure dimensions. Chen and Elder (2007) identified six basic categories under pressure which are transgression of obligations, problems originated from individuals problems, corporate inversion, position achievement and relationship between employees. All of studies refer that perceived pressure or incentives relates to the motivation that leads to unethical behaviour.

Based on the case study that has been discussed earlier, in terms of pressure, top managements for both companies will feel pressure as they want to compete with other company with the same industry. It also can be a pressure for a person that first time did business and thought can generate high profit in any kind of business. Pressure is motivating crime to be happening in the first place.

Perceived Opportunity

According to Kelly and Heartley (2010), the concept of perceived opportunity lead people takes advantage of circumstances available to them. Fraudster will take an opportunity when they make an assumption that the employer is unaware, the assumption that employees are not checked regularly for violating organizational policies, the belief that no one will care with what they did and none of them consider their action or behaviour is serious offense (Sauser, 2007). This is due to weak control system in company as not realize what is happening. Andrew (2012), opportunity refers to a weakness in the system where the employee has the power or ability to exploit the situation and, making fraud possible. The weak board of directors, lack of control, failure to discipline fraud perpetrator, and lack of access information is example the fraudster take opportunity to do fraud. Ewa and Udoayang (2012) stated that fraud can be done by someone that have gained sufficient knowledge of how to commit the crime successfully without fear and stress plus, the internal control are weak.

As an illustration, from the case study above, we can clearly observe that the top management are able to commit fraud when there is a weak internal control as well as poor management oversight. They believe that no one will notice if funds are taken, begins the fraud with a small amount of money. Then, the amounts grow larger. In this context, both companies have failed to review its standard operating procedure to ensure public funds are not misappropriated for personal interest. So, it is more important that the internal control such as supervision need to be effective and efficient.

Rationalization

Rationalization refers to justification that their action is not unethical and it is not a crime. This will lead to fraud activities. According to Cressey (1953), rationalization of fraud make fraudster said that "I was only borrowing the money", "I was entitled to the money", "I had to steal to provide for my family", "I was underpaid or my employer had cheated me." If the

person has integrity, those all word will not be mention as what Rae and Subramanian (2008) said that rationalization is a justification of fraudulent behaviour because of an employee's lack of personal integrity, or other moral reasoning. This is also due to past situation where none of action taken when they did unethical behaviour previously and tend to do it again as they thought they will never get caught. According to Kenyon and Tilton (2006), whenever fraud has occurred in the past and management has not respond appropriately, fraudster will conclude that issues are not taken seriously and can get away from it.

In cases that have been mentioned, the fraudster said or make a reason sometimes can be heard logic. They will say that they did not know it is wrong or they will accuse the company for set to high objective that they need to achieve. Since it is hard to achieve, they tried to use an "easy" way by doing fraud.

Capability

Usually person that commits crime is someone that has necessary traits and abilities and has capability to pull it off. The fraudster has recognized this particular fraud opportunity and can turn it into reality. Position, intelligence, ego, coercion, deceit and stress, are the supporting elements of capability (Wolfe and Hermanson 2004). The fraudster is someone that capable to exploit internal control weakness and take that as their advantage for unethical behaviour. Fraudster very confidence with their doing since they are not easily to get caught, According to Wolfe and Hermanson (2004:40), the more confidence the person, the lower the estimated cost of fraud will be. Furthermore, fraudster is very confidence since they are an important person and have high influence on others. Albrecht et al. (1995) believe that only the person who has an extremely high capacity will be able to understand the existing internal control, to identify its weaknesses and to use them in planning the implementation of fraud. It is quite difficult to caught fraudster that is in high position as according to Wolfe and Hermanson (2004:39), the person position or function within the organization may furnish the ability to create or exploit an opportunity to unethical behaviour or fraud for not available to see from others.

Both cases that mentioned the fraudster are someone that are in high position. They thought they will not get caught since the fraudster is an important person in a company. Other employee also does not dare to blow the whistle as they will lose the job. The fraudster seems to control their employee so that they will not get caught and no one will dare to report their wrong activities.

CHALLENGES AND RECOMMENDATIONS

Generally, there have been many alternative to address this issue. But, still the challenges to avoid corporate failure occur. Based on the previous analysis, several actions need to be taken to overcome this issue.

Firstly, there is need to establish a good company culture. This can be done by all the parties from lower to top management create integrity as a culture and norms in the company. Lack of

integrity and accountability is the main reason corporate failure occurs based on the two case studies above. One quote from Ahamd Shauqi, Arab poet has said that "Nation survive as long as their morality is alive, when morality is gone, they too perish."

Besides that, Warren Buffet has once said that "In looking for people to hire, you look for three qualities. The qualities include integrity, intelligence, and energy. And if you don't have the first, the other two will kill you. If you hire somebody without integrity, you really want them to be dumb and lazy." These two quotes indicate that the value of integrity is really an important subject matter.

An initiatives made by Malaysian Anti-Corruption Commission (MACC) is to produce an academic book entitled 'Islam and the Issue of Corruption is a good alternative. This book generally can help people to have better understanding about corruption and the implications from the perspective of religion and society. Moreover, it can educate people to practice integrity in daily life. This book focuses on corruption from the Islamic point of view and also lessons from the Prophet Muhammad (PBUH). ("MACC launches 'Islam and the issue of Corruption', 2015).

Ethics can be described as the process by which individuals, social groups and societies evaluate their actions from the perspective of moral principles and values. (Blackburn, Klayman and Malin, 1985). In terms of Islamic perspective, ethics is related to the principle of trust or amanah. If a person has a strong value of trust or amanah, he or she will become responsible, sincere to the customers, community as well as environment.

To sum up, it is highly recommended an organization to have the right person and at the right place for the right decision. It is also depend on the systems or regulation to ensure good performance of the company; and also need to ensure the integrity of the person who involves in the decision making. Without integrity, everything would be meaningless. Another recommendation is every organization need to ensure the effectiveness of their internal control system. This means that each company needs to implement effectiveness and efficiency of operations, transparency in financial reporting and also the company's' compliance with laws and regulations. This will reduce the capabilities of someone in high position to do fraud, as other employees aware that there is a channel to report the fraudster activities. If internal control system is good, the person will not dare to do fraud as they will get caught easily. They will also no opportunity for them.

Standard Operating Procedure (SOP) is very crucial in every organization as it can effectively monitor financial transaction, allocation as well as the selection and award of projects tendered. Having a good Standard Operating Procedure is to ensure public funds are not misappropriated for personal objective. The purpose of this code of ethics is to create integrity, responsibility and trustworthy leaders. The right tone at the top is also important as employee tends to follow what leader does. Opportunity to do fraud will be lower as what they did need to be reported. Fraud activities can be detected if they not follow SOP accordingly.

Next is enforcement and monitoring. All the organization in Malaysia has laws and regulations in guiding corporate failure. However, having the strong laws is not enough, but the top

management must be supported by efficient enforcement as well as monitoring. Enforcement and monitoring need to be implemented without fears. As an illustration, the organization needs to strengthen the roles of corporate governance such as strengthening the requirements on the audit committee as well as board of directors characteristics. However, corporate governance is not just about law; it is also about directing and controlling a company through practices, structures and processes. The fraudster will not have an opportunity to do fraud as they have been monitored. They will be no reason when they said they did not know it is unethical as enforcement has been done. Rationalization will reduce and all employees and employers will do their job with integrity.

After that, leaders need to ensure they always monitor the performance of the company so that the company always keeps on the right track. As an illustration, in the case of Sabah Water Department, The Deputy Chief Minister Tan Sri Joseph Pairin Kitingan, claimed that they need to set up a monitoring system. (“Sabah’s colossal corruption,” 2016). Hence, on-going monitoring is crucial which includes regular management and supervisory activities. Then, it is better to have external auditors or someone outside from the company for the check and balance purpose. Overall, this will help by ensuring that the organization is properly run, managed and accountable to the stakeholders.

Based on the two case studies above, government agencies have to implement value management by ensuring that the projects really benefit the target groups. As an example, our honorable Prime Minister, Dato Seri Najib Tun Razak also has encouraged public servants to implement value management in the management of all government projects. He gives an example that there is special reward will be given to any officials or group of officials who perform the best in giving major reduction of the cost. (Najib Razak, 2010). This is important as it will increase public confidence towards the ability of civil servants. If not, it will give a bad impression among the public about the ability of civil servants in managing their funds.

In addition to these, Chief Secretary to the Government, Tan Sri Ali Hamsa has proposed that government worth RM5000 million and above should require the participation of the Auditor-General and the Malaysian Anti-Corruption Commission (MACC) in order to combat corruption. (“Projects worth RM500m and above must now include AG, MACC to avoid corruption,” 2016). The involvements of both agencies are crucial as it is a proactive method to prevent leakages as well as corruption in the public service. This alternative can be looked as a new paradigm to overcome corporate failure issue in Malaysia.

LESSONS LEARNED

Corporate governance is crucial when majority of big companies collapse. Every country around the world especially Malaysia has tried their best to find solution in addressing this issue. Currently, there are many alternatives done by government to build up the good image and reputation for corporate governance. Based on the analysis, one important lesson to be learned is that integrity as well as accountability reflects good corporate governance. Tan Sri Dr Abdul Samad Alias, former president of the Malaysian Institute of Accountants, “Integrity is really a matter of who you are when no one is around”. (Ishak and Hasnah, 2016). In this

aspect, accountability refers to the responsibility of public servants towards the government expenditure. Organizations must be wise its spending wastage and mismanagement must be eliminated from expenditure.

Corruption issues can only be discussed if basic issues like the level of integrity and honesty are resolved first. These elements need to be inculcated within the organization. Good corporate governance can be achieved if economy and technology efficiency is present and there is social and spiritual development. It can be seen from the two cases discussed that lack of integrity and accountability among top management are the main reasons for corporate failures. Civil servants are custodians of the public interest and thus must uphold the trust of the civil servants at all times.

What is more important is that every company must observe their code of ethics and how to perform or behave ethically. Ethics means 'doing the right things'. Corporate values can be influenced from within an organization, but what is important is corporate values are derived from the top. Basically every individual must play their role as many people practice normative behaviour. According to Gillian Fournier the normative social influence involves conforming in order to be accepted or liked by a group, not necessarily because one actually believes the things one is doing or saying. Meaning to say normative is like to follow what other doing. That is why top person need to behave goods and follow code of ethics, as their employees will follow. In addition to this, another crucial lesson that can be learned is managing the risk associated with the business efficiently. This is important as it can help top management make best use of their available resources. There are seven steps that companies need to identify. The basic process includes:

- i. Establishing the context
- ii. Identifying the risks
- iii. Analyzing the risks
- iv. Evaluating the risks
- v. Treating the risks
- vi. Monitoring and reviewing and the lastly
- vii. Communicating the risks

The Malaysian government, under the leadership of the honourable Prime Minister, Dato Seri Najib Tun Razak is very committed to ensure that the corporate governance should be competitive by adopting the right ethical values in running the organisations.

To have good corporate governance, every party including the regulatory agencies, professional bodies, corporate leaders as well as shareholders and investors need to cooperate to enhance corporate governance in Malaysia. Like Hamka has said that, "In the 1960s, while we are now able to create cities and modern concrete jungle, yet at the time the soul of inhabitants appear to be empty and bereft of meaning."(Ishak and Hasnah, 2016).

Former Bank Negara Malaysia (BNM) Governor, Tan Sri Zeti Akhtar Aziz has stressed that institutional building need to involve strong governance to provide the structural foundation necessary to ensure survival in more challenging times. She also added that weak governance

in both the private and public sectors have resulted in poor investment decisions, excessive risk taking as well as irregular practices. Besides that, failure of corporate governance will lead to loss in financial term and at the same time loss of reputation. ("Good governance imperative for building sustainable institutions,"2016).

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