CORPORATE GOVERNANCE PRACTICES AMONG MALAYSIAN SMEs: AN EXPLORATORY STUDY

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ABSTRACT

Many corporate collapses and accounting scandals were due to poor corporate governance practices. Consequently, demands from investors have pressured the regulators to incorporate governance disclosures in the formulation of financial accounting standards. This wave of change also can be observed in Malaysia through the new commencement of Malaysia Private Entities Reporting Standards (MPERS) that have been adopted to tailor to the small and medium enterprises (SMEs) environments. However, the issue arises as to whether improvements in accounting standards have been effective in reducing agency costs and therefore enhancing companies' corporate governance practices. Therefore, the incorporation of governance elements in the accounting standards is crucial to encourage SMEs to engage with good corporate governance practices. Recognising the importance of comprehensive corporate governance practices to SMEs, it is significant to conduct a study concentrating on the level of corporate governance practices among Malaysian SMEs. Therefore, this study attempts to understand the establishment of corporate governance mechanisms and practices among SMEs in Malaysia. In doing so, the presence of three characteristics of good corporate governance (i.e. the proportion of independent non-executive directors, the proportion of independent members of the audit committee, the practice of separate CEO and chairman of the board) in SMEs' operational practices, and perhaps, seconded by information in their annuals reports will be examined. In this study, a qualitative approach and content analysis will be utilized for data collection. This study will help us to understand and examine the factors that push SMEs to engage or abandon comprehensive corporate governance practices.

***Keyword**: Corporate Governance; SMEs; Malaysia; MPERS*

INTRODUCTION

Weakness in corporate governance and lack of transparency are considered causes of the Asian financial crisis, and the subsequent events of corporate collapses and accounting fraud. Consequently, investors have demanded improvements in governance practices which lead to the implementation of corporate governance codes as the guidelines for companies to improve their governance and disclosure practices. The issue arises as to whether these improvements have been effective in reducing agency costs and therefore enhancing company disclosure. According to Abdul Hadi et al. (undated), financial transparency is an important mechanism that provides depositors, creditors and shareholders with the credible assurances that they will not do fraudulent activities. Therefore, the audited financial statements comprise a crucial part of the financial reporting system that is required for effective corporate governance. Further, Beasley et al. (2000) have suggested the need for auditors to acknowledge weak governance mechanisms that are related to financial fraud across a number of time periods and industries.

The importance of small and medium-sized enterprises (SMEs) in a country's economic development is undisputable. In most countries, SMEs take a large share of the number of enterprises, employment, sales revenues and exports (OECD, 2002). They are also considered as the major source of employment and innovation (Le and Quang, 2005). Although SMEs play a critical role in transitional economies, their accounting practice is a controversial matter. SMEs are required to prepare their financial statements in accordance with a complicated regime of accounting and financial reporting regulations and standards. Recently, the International Accounting Standards Board has published a single set of accounting standards for SMEs and this represents a major simplification of financial reporting for smaller entities (IASB, 2009). Since accounting standards are an integral part of the national accounting system, however, it is recognised that very little is known about the corporate governance practices, especially in the context of SMEs.

Despite the lack of relevant academic literature of accounting standards for SMEs, it is generally known that disclosure is one of the fundamental goals of financial reporting system as it becomes a tenet of any corporate governance system. As highlighted by Melis (2004), a good system of corporate governance requires a good level of disclosure and adequate information to reduce information asymmetries between all parties and making corporate insiders accountable for their action. The financial reporting system represents the main mechanism to provide adequate information to shareholders. As such, financial reporting and disclosure can limit the top management’s discretion to pursue their own interest.

Recognising the importance of corporate governance mechanisms adequacy in financial management, it is significant to have a study focusing on the level of corporate governance practices among Malaysian companies. Hence, this study attempts to find out whether the established corporate governance mechanisms; namely the proportion of independent non-executive directors, the proportion of independent members of audit committee, the practice of separate CEO and chairman of the board, particularly in one of emerging market such as Malaysia. Since the study of corporate governance practices at SMEs setting is still at infancy level, the study will utilise qualitative approach in exploring the Malaysian SME’s corporate governance practices.

LITERATURE REVIEW

The International Financial Reporting Standards (IFRSs) are global accounting standards that work as the main reference for financial reporting guidelines for private entities, especially for listed companies. The application of IFRSs has benefited the big corporations listed on the stock exchange, as a result, the global business community has put some pressure on the non-listed companies to have similar financial reporting standards. Among the reason is, that it is believed that about 99% of the companies established in the world come are non-listed organizations. Furthermore, in many developing countries including Malaysia, these non-listed companies played important roles in domestic growth and economic development. As evidence, SMEs in Malaysia make up 99% of the total business establishment and contribute to 36.3% of the nation’s Gross Domestics Product (GDP) in 2015 (National SME Development Council 2016). Thus, it is hoped that the benefits of having sound financial reporting standards enjoyed by the listed companies will be also shared by the non-listed companies.

Therefore, Malaysia has developed and adopted IFRS for SMEs and named it as Malaysian Private Entities Reporting Standard (MPERS). Before 2016, private entities have a choice of continuing with the existing Private Entity Reporting Standards (PERS) Framework or applying the Malaysian Financial Reporting Standards (MFRSs) Framework (mandatory for non-private entities, except transitioning entities), or by 1 January 2016, mandatory migration to the new

MPERS Framework. The rationale behind the adoption of accounting standards was due to the concept of “decisionusefulness” which explains accounting as a process of offering the relevant information to the relevant decision makers (Staubus, 1961, 1977).

However, despite the incorporation of new reporting standards (i.e. MPERS) for SMEs was argued will provide better information for decision making, many shreds of evidence pointed out that lack of corporate governance information and practices leads to a loss of investor confidence in trusting companies’ financial activities (Tan, 2000; Mishra, Randoy and Jensen, 2001; Mitton, 2002). The reason is due to lower transparency in emerging markets such as Malaysia exposed to higher levels of asymmetric information and decreases in firm value (Jensen and Meckling, 1976).

Prior research has analysed corporate governance practices from an agency perspective and hypothesises that corporate governance is related to information asymmetry between management and investors (Diamond and Verrecchia,1991; Lang and Lundholm, 1993 and 1996). In addition, previous studies mostly investigate the link between financial practices and firm-specific characteristics (e.g. Wallace, Naser, and Mora, 1994; Ahmed and Nicholls, 1994; Hossain, Tan, and Adams, 1994). However, most studies on corporate governance disclosures and/or practices are related to publicly listed companies, especially post ENRON case, and there has been little research linking corporate practices to governance structures among SMEs (except the following, Graafland, van de Ven, and Stoffele, 2003; Parsa, Chong and Isimoya, 2007; Del Baldo, 2012; Son Dang-Duc, 2011; Calace, 2014).

This proposed research has one main objective which is to examine the accounting and corporate reporting practices among SMEs in Malaysia. Studying the corporate governance practices among Malaysian SMEs will provide additional insights into elusive SME’s financial management framework and at the same time enhances our understanding of the accounting and disclosure practices of SMEs. To investigate the SMEs’ corporate governance practices, this study will be adopting Wan Mohammad and Sulong (2010) three characteristics of corporate governance in identifying SMEs’ corporate governance practices among SMEs. Hence, for listed companies, the company is highly encouraged to prepare other types of reporting such as statements on corporate governance, corporate social reporting, chairman and chief executive’s statement, management analysis, discussion statements, and many other narrative reporting (Salin, 2017). Thus, Wan Mohammad and Sulong (2010) study on corporate governance practices among public listed companies is suitable to be utilized in examining SMEs’ corporate governance practices. The three corporate governance characteristics are;

The numbers of independent non-executive directors on board

The Board of directors’ key role is to monitor management decisions. There are two types of directors on the board, namely executive and non-executive. Executive directors have direct responsibility for managing the business such as finance and marketing since they are full-time employees of the company (Weir & Laing 2001). Meanwhile, non-executive directors (NEDs) are needed to provide independent judgment such as pay awards, executive director appointments, and dismissals when dealing with executive directors. As such, to have an effective control mechanism, the board of directors must be independent, in other words, mainly consists of non-executive directors. Forker (1992) also argued that a higher number of non-executive directors on board would enhance the monitoring of financial disclosure quality and reduce the risk of information concealment.

The numbers of independent non-executive directors in audit committee

The main duty of the audit committee is to meet the external auditors regularly to review financial statements, audit processes, and internal accounting systems and control. Therefore, to ensure the establishment of the audit committee will ensure that there is continuous communication between the board and external auditors (Rashidah & Fairuzana 2006). Moreover, there is a study undertaken by Barako et al. (2006) in Kenya found that the presence of an audit committee will improve financial transparency among Kenyan companies.

The practice of separate CEO and chairman of the board

Commonly, most companies practiced the role of duality, in which the CEO also holds a chairman role on the board. This practice leads to the high probability that people who hold both positions (i.e. CEO and board Chairman) withhold unfavorable information from outsiders. Besides, this role of duality provides the opportunity for the CEO to engage in opportunistic behaviour since he/she upholds strong power and influence over the board. When CEO duality exists, it might hamper the decision making process since the risk of conflict of interest might occur because the CEO needs to monitor both its own decisions and actions, thus actions in the best interest of the shareholders may not be performed. Furthermore, in Malaysia, there are no mandatory rules for the separation of roles between both chairman and CEO. The adoption is recommended in the Malaysian Code to separate the roles of chairman and CEO. In the corporate governance system, having an independent chairman would lead to a more transparent board and enhance greater disclosure and governance practices.

METHODOLOGY

In this study, a qualitative approach to data collection will be employed. The detail of the methodology used in this study is as followed; A qualitative approach is chosen for the proposed research due to the exploratory nature of the research. Exploratory research based on an inductive perspective allows the researchers to get insight into a specific topic. Thus, qualitative research is seen as a suitable platform to investigate a research issue that has not been studied more clearly with the intention to establish priorities, develop operational definitions and improve the final research design (Gillham, 2000). Therefore, the research will utilize several qualitative research methods such as interviews, observation, as well as reviews of other secondary or archival data (non-financial documentation). The study covers the direct and indirect key players in the formulation and development of accounting standards in Malaysia such as the Malaysian Institute of Accountants (MIA), the Malaysian Accounting Standard Board (MASB), the Financial Reporting Foundation (FRF), the accounting professional bodies such as ACCA and MICPA. Few companies from the SMECorp database will be selected for interviews. A qualitative approach will be utilized and to gather the relevant information, several semi-structured interviews will be conducted, and the data analysis will be based on the content analysis method.

EXPECTED RESULTS/BENEFITS

This paper argued that knowing the number of SMEs that have incorporated all three characteristics of good corporate governance would improve our understanding of the level of embeddedness of corporate governance practices element in the formulation of the companies' operational and financial framework. The absence of good corporate governance characteristics embedded in the formulation of companies' operational and financial systems will impair the objective to better off the quality of financial information presented in the SMEs' annual reports This is because having a strong governance practice will lead to improved financial disclosure is a key tool in building a higher quality of transparency. Consequently, it creates confidence among the shareholders/investors who then pay higher prices for the stock, and hence, enhances the ability of a firm to raise its product/brand reputation among the public and consumers.

SUMMARY

Having corporate governance will help investors to understand the company's affairs and subsequently reduces the gap between management and investors. According to agency theory, firms increase their best practices (both operational and financial) to avoid potential pressures from regulatory authorities. Plain and simple adoption of corporate governance rules will slowly impair a higher level of integrity among Malaysian private corporations. To achieve high-quality financial information and resources, the Malaysia government needs to incorporate an effective institutional mechanism, i.e., corporate governance, with comprehensive statuary practices in the accounting and auditing standards, it was not only able to supervise and monitor managers but at the same time it able to reduce agency cost through upholding a firm's image and reputation to the public (Akhtaruddin, Alam Hossain , Hossain, and Yao, 2009). Thus, the research findings are expected to produce new findings through the identification of internal and external factors that play significant roles for SMEs to incorporate comprehensive corporate governance practices.

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