

BOARD EFFECTIVENESS OF MALAYSIAN SMALL AND MEDIUM
ENTERPRISES (SMEs)

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DEDICATION

*To my only God,
Allah almighty, the most merciful, the most gracious*

*Beloved Parents
Hj. Adi, Hjh Sujinah, Hj. Umar and Hjh Juhada*

*Lovely Partner
Anis*

*Adored Jewels
Hanan, Habib, Nawwfal, Wawa and Wafa*



PTTHM
PERPUSTAKAAN TUN AMINAH

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ABSTRACT

Over the past three decades, there has been a considerable number of corporate governance research. Most researchers found that SMEs are marginalised, and without clear guidelines, unscrupulous directors are most likely to breach trust. The primary objective of this study is to develop a new framework of board effectiveness for Malaysian SME boards. The current study employs a qualitative design to investigate the research objectives through the lens of a phenomenological approach. The information was gathered through eighteen semi-structured interviews. In addition, secondary data from a hundred E50 award recipients were analysed to support the findings. The data was analysed using thematic analysis, which was carried out using NVivo 12 plus. As a result, the key findings of the studies are that for the SME board to function effectively, (1) Directors must have a broad range of knowledge and skills in various areas, including business management, finance, basic legal corporations, firm-specific knowledge, and others. (2) The board should comprise the optimal number of directors. (3). The board's behaviour debate, teamwork, leadership, commitment, involvement, integrity, employee engagement, openness, and wisdom are essential. (4) Furthermore, the decision of the meeting must consider the opinions of the majority of the attendees. Lastly (5), it is also important to consider the tasks and roles of the board, which include the following: vision and mission; finance; human resource management; management; marketing; production and operation; strategic planning; fiduciary responsibilities; succession planning; and separation of powers. To sum up, Malaysian SMEs require a comprehensive, and integrated corporate governance policy or guidelines that reflect a holistic board effectiveness mechanism. The study also recommends that policymakers carefully consider the specific fundamental roles that directors must play to carry out their responsibilities.

ABSTRAK

Beberapa dekad yang lalu, terdapat banyak penyelidikan mengenai amalan tadbir urus korporat. Sebilangan besar penyelidikan ini mendapati bahawa PKS (Perusahaan Kecil dan Sederhana) seolah-olah dipinggirkan tanpa panduan atau kod yang jelas. Objektif utama kajian ini adalah untuk membangunkan kerangka keberkesanan lembaga pengarah yang baharu untuk PKS di Malaysia. Kajian ini menggunakan reka bentuk kualitatif untuk mencapai objektif penyelidikan melalui lensa pendekatan rekabentuk fenomena. Pengumpulan data dilakukan terhadap lapan belas responden menggunakan teknik wawancara separa. Selain itu, data sekunder daripada seratus penerima anugerah E50 (Enterprise 50) dianalisis untuk menyokong penemuan penyelidikan ini. Data dianalisis menggunakan analisis tematik dibantu dengan perisian *NVivo 12 plus*. Hasil penemuan utama kajian ini adalah, untuk lembaga pengarah PKS berfungsi dengan berkesan, (1) Pengarah harus memiliki pengetahuan dan keterampilan yang luas dalam berbagai bidang, termasuk pengurusan perniagaan, kewangan, asas undang-undang syarikat, pengetahuan khusus firma, dan sebagainya. (2) Komposisi lembaga pengarah harus terdiri daripada jumlah yang optimal (3) Tingkah laku ahli lembaga pengarah seperti kerja berpasukan, kepemimpinan, komitmen, penglibatan, integriti, keterbukaan, dan kebijaksanaan amat penting (4) Keputusan mesyuarat juga mesti mengambil kira pendapat majoriti yang hadir. (5) Tugas dan peranan lembaga pengarah, yang perlu dititikberatkan: visi dan misi; kewangan; pengurusan sumber manusia; pengurusan pemasaran; pengeluaran dan operasi; perancangan strategik; tanggungjawab fidusiari; perancangan penggantian; dan pemisahan kuasa. Kesimpulannya, PKS di Malaysia memerlukan dasar atau garis panduan tadbir urus korporat yang komprehensif dan bersepadu yang mencerminkan mekanisme keberkesanan lembaga secara menyeluruh.

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LIST OF SYMBOLS AND ABBREVIATIONS

BNM	-	Bank Negara Malaysia
CEO	-	Chief Executive Officer
CCM	-	The Companies Commission of Malaysia
GDP	-	Gross Domestic Product
HKIoD	-	Hong Kong Institute of Directors
KLSE	-	Kuala Lumpur Stock Exchange
MAICSA	-	Malaysian Institute of Chartered Secretaries and Administrators
MASB	-	The Malaysian Accounting Standards Board
MCCG	-	The Malaysian Code on Corporate Governance
NEDs	-	Non-Executive Directors
RBS	-	Royal Bank of Scotland
SC	-	Securities Commission
SMEs	-	Small and Medium Enterprises
OECD	-	Organisation for Economic Co-operation and Development
UK	-	United Kingdom

CHAPTER 1

INTRODUCTION

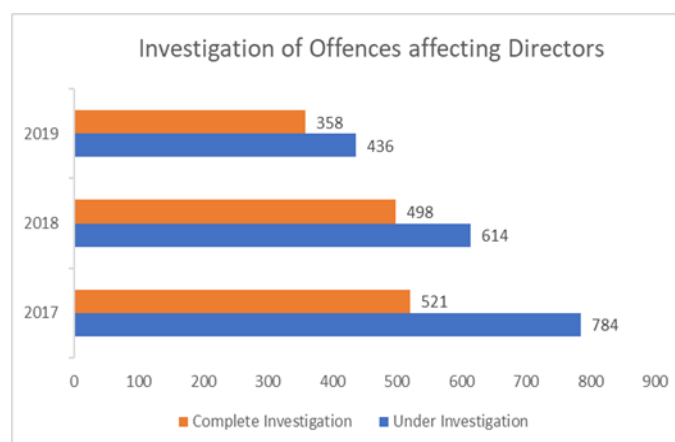
1.1 Introduction

The failure of large corporations throughout the world has shown flaws in corporate governance practices. In the wake of the collapse of giant firms such as Enron, Worldcom, and Tycon in the United States, Parmalat in Italy, and HIH Insurance in Australia, questions have been raised about the importance of corporate oversight mechanisms (Mustapha, Rashid, Bala, and Musa, 2020). A number of lessons can be gleaned from the failures of corporations. One of the explanations suggests that the board of directors has unbridled power and that mismanagement has occurred (Rossouw and Styan, 2019).

The board plays a significant role in ensuring that the firm performs well. Abundant literature found that firm performance is much associated with board effectiveness (Makhlouf, Laili, Basah, and Ramli, 2017; Martinez-Jimenez, Hernández-Ortiz, and Cabrera Fernández, 2020; Nordberg and Booth, 2019). There is no universal standard of board effectiveness concept. However, it is succinctly defined as the ability of the board to perform its various functions and ensure the firm's performance (Nordberg and Booth, 2019).

The problem of the board is a long-standing concern in the business environment. In Malaysia, the board that violates corporate governance practices is

recorded in statistics issued by the Companies Commission of Malaysia (CCM). The following statistics depict the above concern,



1.1: Number of investigations affecting directors (CCM Annual Report 2019)

The above figure illustrates the number of investigations affecting directors issued by the CCM. It shows that cases involving directors who were reported to violate the laws were consistently high from 2017 to 2019. Most of these cases affected small companies and businesses such as private limited companies, partnerships, sole proprietorship, and limited liability partnerships.

In Malaysia, the infamous corporate scandal that fuelled public outrage is 1MDB. It is considered one of the world's largest scandals involving the former Prime Minister of Malaysia (Chea, 2021). The charge against him has blighted his political career. Recently, Transmile Group Bhd founder and former CEO were jailed and fined by the Session Court for furnishing a misleading statement to Bursa Malaysia (Securities Commission, 2020). Both cases have attracted the public and investors' concern over the effectiveness of present corporate mechanisms to curb the unscrupulous conduct of the directors.

In addition, Figure 1.2 further depicts the number of business entities investigated in 2019 in which the majority affected SMEs compared to public companies.

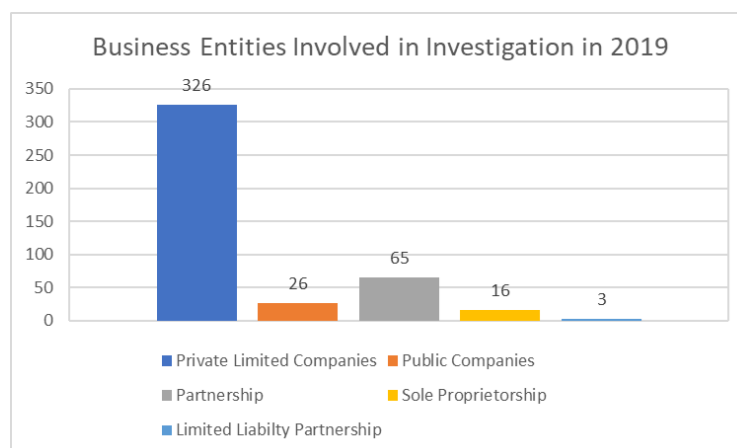


Figure 1.2: Business entities involved in the investigation in 2019 (CCM Annual Report, 2019)

This thesis reports the finding of a rigorous study to explore factors that are important for the board's effectiveness. The outcome of the study can be applied to develop a framework of board effectiveness in Small and Medium Industries (SMEs). Emphasis is placed on the board's characteristics, composition, behaviour, meeting, tasks, or roles. Also, central to the research of the study is the external environment of the board that may bring about its effectiveness.

Thus, to address this issue, the current study primarily employs interviews as the main instrument to explore the participants' lived experiences in explaining the essential components of the effectiveness of Small and Medium Enterprises (SMEs) boards. The following chapter provides the overview of the study, which encompasses the study's background, the problem statement, research questions and objectives, scope and significance, and operational definition.

1.2 Background of the Study

SMEs are the breakthrough of the Malaysian economy. Based on the census issued by SME Corp in 2020, it is evident that the total number of SMEs operating in Malaysia in 2020 is 1,151,339 representing 97.2% of overall business establishments (SME Corp, 2020). This number has considered a current definition of SMEs, which came into effect on 1st January 2014. In terms of SME performance, the SME Gross Domestic Product (GDP) contributes RM512.8 billion (38.5% share). While SME

exports contribute RM117.8 billion (13.5% share). The SME employment marks 7.25 million workers (48% share). Figure 1.3 depicts the number of SMEs establishment by section in 2020. On average, the number of SMEs increased by 4.9% every year since 2015 (SME Corp,2020).

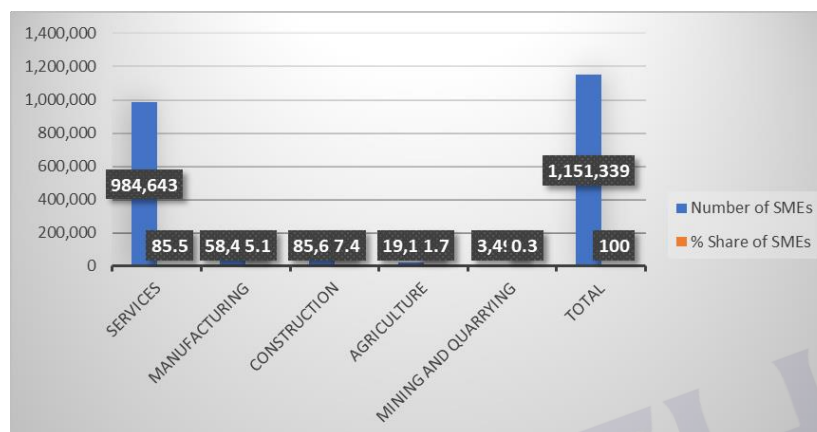


Figure 1.3: Number of Malaysian SMEs in 2020 (SME Corp,2020)

Based on the above figure, the services sector has continuously reported more than 80% of all SMEs, accounting for 85.5 per cent of 984,643 SMEs in 2020. The construction industry surpassed agriculture in the same year to become the second-largest contributor, accounting for 7.4 per cent of total contributions (85,637). Meanwhile, over 5.1 per cent of SMEs (58,439) were active in manufacturing, followed by 1.7 per cent (19,130) in agriculture, and the remaining 0.3 per cent (3,490) in mining and quarrying.

All SMEs' Gross Domestic Product (GDP) contributions by type of economic activity increased in 2020, except for the services and manufacturing sectors. As shown in Figure 1.4, the agriculture sector continued to dominate SMEs' GDP with 54.0 per cent, driven by rubber, oil palm, livestock, and other agriculture sub-sector. The contribution of SMEs to GDP in the construction sector increased to 48.7 per cent in 2019 from 46.4 per cent in 2018. The SME GDP of the services sector fell to 41.0 per cent from 42.7 per cent the previous year, driven by the wholesale & retail trade, food & beverage, and lodging sub-sector. The manufacturing sector contributed 34.5 per cent of SMEs' GDP, fueled by petroleum, chemical, rubber, and plastic products.

Meanwhile, SMEs' GDP in the mining & quarrying sector accounted for 3.0% of total GDP. The following figure depicts the above statistics.

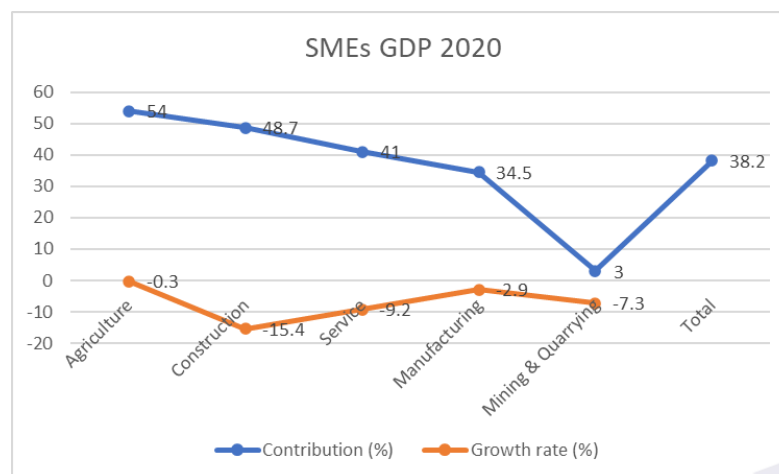


Figure 1.4: Malaysian SMEs GDP 2020 (Department of Statistics Malaysia, 2020)

With regards to corporate governance in SMEs, abundant literature reported that good governance is essential for the firm's success and performance (Kurniawati and Kartika, 2018; Mahzan, Meng, and Yan, 2014; Sarah, 2017; Usman, Hartani, and Sroka, 2020). Board effectiveness, in particular, has been found in a large body of studies as one of the integral predictors that intertwine firm performance (Bhattarai, 2013; Choi et al., 2014; Conheady et al., 2015; Irshad and Ali, 2015; Kassim et al., 2013; Mensi, Boubaker, and Aloui, 2012). As such, the board of directors is one of the prominent corporate mechanisms that protects the interest of the shareholders (Kassim, Ishak, and Manaf, 2013).

In addition, board effectiveness is the outcome of the governance structure, board processes, and roles played by members of the board (Arosa, Iturralde, and Maseda, 2013; García-Ramos and García-Olalla, 2011; Heemskerk, Heemskerk, and Wats, 2015; Leblanc and Schwartz, Shehata, Salhin, and El-Helaly, 2017). Despite its significance on the firm performance through the role of members, the issue of board effectiveness among SMEs has received limited attention in the literature (Iturralde et al., 2016). Much of the work is concentrated in public or listed companies. Only a few studies were conducted linking the factor of board directors with small firms'

performance in Malaysia (Iskandar et al., 2017; Aziz and Yazid, 2015; Omar, Lim, and Basiruddin, 2014).

Given the above concern, the present study pays much attention to the effectiveness of the board. A fundamental framework of board effectiveness developed by Forbes and Milliken in 1999 was adapted to guide the current study. The following figure depicts the forwarding strategy.

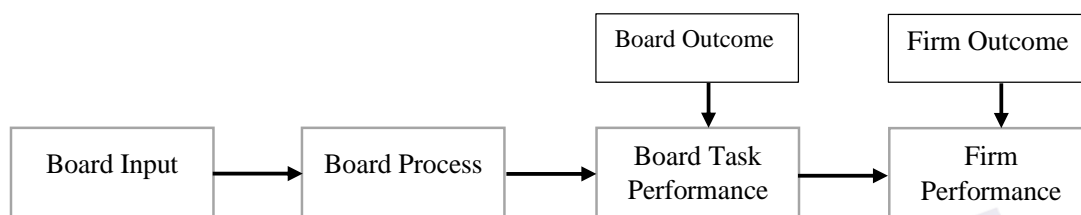


Figure 1.5: Board effectiveness framework (Adapted from Forbes and Milliken 1999)

Considering the enormous influence of corporate governance in SMEs on the Malaysian economy, it is justifiable to say that this type of company needs to be facilitated for its sustainability and performance. Thus, based on the above contention, the board effectiveness affecting SMEs needs to be addressed and requires further investigation.

1.3 Problem Statement

Companies require their boards to function effectively. Evidently, an effective board is associated with better organisational performance (Bezemer et al., 2014). The board is said to be effective when it has fulfilled the expected tasks and roles (Forbes and Milliken, 1999). It also requires that the board have essential knowledge, experience, and integrity to lead and run the company (Nkeobuna and Ugoani, 2020). Likewise, boards with ideal size and meetings frequently are shown to drive the firm performance (Saleh and Islam, 2020). An effective board is also a synonym for the board which promotes the interest of the shareholder (Garcia-Torea et al., 2016).

However, many boards in Malaysian SMEs face challenges in managing the companies effectively (Singh and Pillai, 2022). One of the compelling issues is that Malaysian SMEs are left out without clear codes or guidelines that oversee and monitor the board and other related activities affecting the interest of the stakeholders. The problem of board effectiveness is compounded when the directors are involved in serious corporate governance offences. During the Asian Financial Crisis in 1997, it was evident that a considerable number of SME board directors were found to have been involved in illegal activities such as unlawful deposit-taking, fraudulent activities, misleading statements, and others (Umrani, Johl, and Ibrahim, 2015). Relatively, the number of private companies was overwhelmingly investigated for serious offences with 72% more than other business entities (CCM Annual Report, 2019). An interview with a company secretary conducted on 26th July 2018 confirmed some compelling issues regarding board directors of SMEs involving fraud and dishonesty committed. The company secretary observed that “there are some shrewd and unscrupulous directors who tend to deceive their naïve counterparts in managing the company's affairs. The feeble and inexperienced directors are easy prey and suffer the loss.

Moreover, statistics in 2019 issued by Commission Company Malaysia (CCM) showed that there were 168 cases involving board directors committed to the appointment or removal of directors without knowledge and consent (CCM Annual Report, 2019). While 65 cases of directors were involved in registering false information with CCM (CCM Annual Report, 2019). Other offences involving directors were forgery of business information in 41 cases, registration or removal of the business owner without knowledge and consent in 17 cases, transfer or disposal of shares without knowledge and consent in 17 cases, and carrying on business without a license with 6 cases (CCM Annual Report, 2019).

The effectiveness of the board is also undermined when the board is diverse in gender, culture, language, and race (Iskandar et al., 2017; Martinez-Jimenez, Hernández-Ortiz, and Cabrera Fernández, 2020). Many studies also confirmed that Malaysian SMEs have a shortage of marketing skills, industrial expertise, risk management, and strategic vision (Musa and Chinniah, 2016; Mustafa and Yaakub, 2018; Shariff and Abidin, 2018). Statistics also show that directors have some problems in executing tasks and roles. For instance, there are 633 cases affecting

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