Global Business and Management Research: An International Journal
Vol. 7, No. 2 (2015)

Corporate Governance Practices and Problems Faced By SMEs in Malaysia

***Aamir Iqbal Umrani**
Universiti Teknologi PETRONAS

Satirenjit Kaur Johl
Universiti Teknologi PETRONAS

Mohammad Yussoff Ibrahim
Universiti Teknologi PETRONAS

*Department of Management and Humanities, Universiti Teknologi PETRONAS, Seri Iskandar, 31750, Perak Malaysia.
Email: umrani.aamir@yahoo.com

Abstract
Small and Medium Enterprises (SMEs) are vital for economic growth in the emerging economies. SMEs are the big contributor to the GDP and employment in every country. It is important that the corporate governance practices need to be implemented to monitor and control firms and their majority shareholders. The ownership concentration in Malaysian SMEs has resulted in less protection of the minority shareholders. This is because; most of the companies are family based, where the family members hold the top management positions. Therefore, the majority shareholders are involved in the act of expropriation, which results loss of huge amount of money and trust of the minority shareholders. In Malaysia, the SMEs does not have any documented corporate governance code, this creates the problems like expropriation. This study is focused on medium sized SMEs. Furthermore, this study investigates the extent of expropriation of minority shareholders and the necessity to have a comprehensive code to monitor the firms and control the stakeholders, and also it helps to protect the minority shareholders' rights.

Keywords: Corporate governance, Small and medium-sized enterprises, Ownership structure, Expropriation, Minority shareholders

INTRODUCTION

In most of the countries, with a weak legal system, owners of the firms can take resources out of the firm for their own benefit. They simply expropriate the rights of the minority shareholders (Johnson *et al*, 2000; Glaeser *et al*, 2001). However, most of the majority shareholders, who are involved in the expropriation of the shareholders' rights, belong to the owner family.

In Malaysia, expropriation of the minority shareholders rights mostly occurs in the firms with concentrated ownership. Most of the majority shareholders found involved in such kind of activities. This study is focused to explore the extent of expropriation of minority shareholders rights, focusing on the current code of ethics. This study also tries to investigate the need of corporate governance code for SMEs. Furthermore, in this paper, extensive literature review is been carried out to analyze the current management practices in Malaysian SMEs.

MALAYSIAN SMES

Small and medium enterprises (SMEs) have a major contribution to the Malaysian economy, it represent 65% of the total employment in the labor market and 99.2% of the overall SMEs business establishments in Malaysia and (Bank Negara Malaysia, 2006). Malaysian SMEs contribute 32% of the GDP and 19% of the total export value of the SMEs' (NSDC, 206). The contribution of the export value is below the average line compared with the other Asian countries, which is more than 50% (Ndubisi, 2008). Malaysian government is taking several initiatives to promote SMEs in the country to achieve high contribution from SMEs in the economy. Such as, ICT growth for SMEs knowledge based development and the ninth Malaysia plan, effective from 2006 to 2010. The reason is to encourage and empower the growth and establishment of the SMEs in the country (Rachagan & Satkunasingam, 2009). It's been discussed since decades that SMEs are the major components in the economic growth of any country. Similarly, SMEs are the major source of employment in many developed and emerging markets. So far in Malaysia, SMEs are the major contributors towards the overall employment by contributing 57.4% in 2012. Compared with the previous year, the rate of employment increased significantly up to 6.5 % in 2012. Similarly, the employment rate in the year 2011 was also high compared with its previous year. It is shown that, each year the numbers of employees are increasing in the SME sector (SME Corp Malaysia, 2012-13). SMEs have a higher contribution in the overall employment in comparison to the large sized firms (Table 1).

Most of the Malaysian SMEs are family owned. Particularly, 72% family owned firms exists in Malaysia and this is the situation in many developing countries. Similarly, 60% SMEs are family concentrated and they do not practice corporate governance well (Himmelberg *et al*, 2004). Mostly the families have control over management of the firms (Claessens *et al*, 1999; Claessens *et al*, 2002; Khatri *et al*, 2002). According to Ibrahim & Samad (2011), family concentration in Malaysian firms increased from 57.7% to 67.2% and the cut off level for voting has increased from 10% to 20%. They further expressed that, the Malaysian SMEs structure reflects concentrated ownership and high agency cost due to fraudulent behavior of the majority shareholders.

Table 1: SMES, Large Firms and Total Employment (2009 – 2012)

	2009	2010	2011	2012	% share 2012
SME Employment	4,100,952	4,389,823	4,562,815	4,854,142	57.4%
Employment in Large Firms	2,800,097	3,294,714	3,403,549	3,606,829	42.6%
Total Employment	6,901,049	7,684,537	7,966,364	8,460,971	100%

Source: Department of Statistics, Malaysia

EXPROPRIATION OF SHAREHOLDERS' RIGHTS

Expropriation of minority shareholders rights occurs when the majority shareholders take profit of the firms for themselves rather than to return it to the minority shareholders. This means that, the control shareholders can make private benefits on the shareholders' expense. It consists of misappropriation, resisting potentially beneficial take-over offers, selling and buying assets without shareholders' consent. Furthermore, related lending, diverting corporate opportunities from the company, hiring unqualified family members on managerial positions, rewarding themselves with undue pay without performance, taking managerial benefits such as spending profligately and corporate jets (Wan-Hussain, 2005).

Mergers between affiliated companies that drain off resources out of the bidder or the target, ineffective cross subsidization of investment among division, excessive diversification, targeted share repurchases, and dilute share issues that discriminate against minority shareholders are some methods of deceiving shareholders (Wan-Hussain, 2005). There have been accusations that, in Malaysian firms, majority shareholders enrich themselves at the shareholders' expenses through fake invoicing, force bailout, and mutualizing proceeds from capital raising exercise (Rachagan & Satkunasingam, 2009).

The expropriation of shareholders' rights formerly described as the misalignment of interests among shareholder groups or extensive ownership of cash flow rights. Expropriation leads to the majority management, isolation from external corporate control mechanisms, lavish salaries and dividends, or family members in the board of directors without required qualifications (Young, 2002). The likelihood for expropriation of shareholders' rights with the lower economic performance and inadequate investment opportunities in the area restrict the investment and interest of foreign investors, annoying the real low turnover on regional stock exchanges (Rachagan & Satkunasingam, 2009).

The reason for expropriation is that the family members are the majority shareholders of the firm and they can take resources out from the firm for their own good. As they have the power of being majority shareholder in the firm (Shleifer & Vishny, 1997). Such kind of expropriation reduces the market value of the firm (Dahya *et al*, 2008). Firms with majority shareholders involved in expropriation of shareholders rights do not perform well. There is negative relationship between shareholders' expropriation and firm value (Dahya *et al*, 2008; Shleifer & Vishny, 1997; Porta *et al*, 1999; Morck *et al*, 1998; Lins, 2003; Qian *et al*, 2010).

Expropriation activities commenced by the family majority shareholders to enhance their personal utility cause the poor firm performance (Anderson & Reeb, 2003). This poor performance can be seen in inferior returns, weak growth, and poor stock market valuations (Bennedsen *et al*, 2007; Cronqvist & Nilsson, 2003; Maury, 2006; Perez-Gonzalez, 2006).

According to Mork & Yeung (2003), in the emerging economies most of the business belongs to certain business groups and families. Generally, decision making in such firms is controlled by majority shareholders, and they are liable for the consequences (Silva & Majluf, 2008). On the other side, the majority shareholders can enjoy the opportunity to expropriate the firm's resources for their own benefits. But it will affect the other shareholders (Shleifer & Vishny, 1997).

ISSUES IN MALAYSIAN SME SECTOR

Corporate governance failure within the SMEs is a big threat to Malaysian economy, as it is stated that SMEs are the major contributor to the country's GDP (Bank Negara Malaysia, 2006; NSDC, 206), and the major employment sector of the country (SME Corp Malaysia, 2012-13). Malaysian SMEs are the model of family concentrated ownership (Claessens *et al*, 2000), and where ownership became more concentrated, chances for the protection of minority shareholders rights will be low (Silva & Majluf, 2008). In such type of firms, family has the power of decision making, and also their relatives and close friends are being hired as the board of directors. Similarly, the top management positions are kept within the family (Rachagan & Satkunasingam, 2009) and such firms doesn't have good corporate governance practices (Himmelberg *et al*, 2004). Lack of competencies in the business owners and the lack of skills and expertise among the people holding the management position has caused the failure of the most SMEs (Silva & Majluf, 2008).

Most of the SMEs failed to follow the corporate governance reforms from CCM, and it caused many fraudulent activities, providing fake financial and annual reports, illegal

investment schemes which lead to high monetary loss to the outside investors (Longenecker *et al*, 1999). Good corporate governance practices lead firms to good corporate performance, the failure of many SMEs is the result of poor corporate governance practice (Wahab *et al*, 2007). All these problems discussed here have an adverse effect on the corporate governance practices in the SMEs. Due to these problems, most of the SMEs fail, and the failure rate of Malaysian SMEs is quite high at 60 percent (Ahmed & Seet, 2009).

CORPORATE GOVERNANCE ISSUE IN MALAYSIAN SMES

Good corporate governance practices lead firms toward good corporate performance. The Malaysian Code of Corporate Governance was only implemented to the public listed companies in Bursa Malaysia to control and monitor firm's performance according to the corporate governance standards. Similarly, Companies Commission of Malaysia (CCM) is working to meet the good corporate governance practices for the SMEs in the country. CCM is an agency that incorporates companies, register businesses and provide business information to the public (CCM, 2012).

Corporate governance mechanism can be divided into two major mechanisms: internal and external control. The main external control mechanisms are the market for corporate control, managerial labor markets and concentrated shareholding by block-holders. On other side, there are two essential internal corporate governance mechanisms; the director's shareholding and board of directors (BOD). Due to the weak market control, the internal corporate control mechanisms play a vital role in the corporate governance mechanism in the emerging economies (Ahmed & Seet, 2009).

Asian Financial Crises of 1997 put their marks on Malaysian firms as well, and it revealed the poor corporate governance practices in the country (Wahab *et al*, 2007). Most of the companies suffered from over leveraging, allegations of cronyism and poor legal protection for investors against expropriation due to corporate insiders (Claessens *et al*, 1999). These issues became worst due to lack of corporate take overs in Malaysia and politically connected firms in the country (Ahmed & Seet, 2009; Faccio & Lang, 2002).

Internal corporate governance mechanism is essential for successful corporate governance. Most of the Malaysian SMEs failed to follow the corporate governance rules. Due to this imbalance, many SMEs are involved in different sort of fraudulent activities, such as; lodgment of false and misleading particulars, illegal deposit taking, illegal investment schemes. The illegal investment schemes affect many investors and involved huge amount of money. Furthermore, according to the CCM that all companies registered under the CCM are required to submit their annual reports, annual returns, tabling accounts and conducting annual general meetings. In spite of that, most of the SMEs failed to follow these guidelines, and it was found that SMEs in Malaysia tend to submit misleading statements (CCM, 2012). Most of these issues occur due to concentrated ownership (Claessens *et al*, 2000). Most of company owners, directors and secretaries are found involved in various fraudulent activities. For instance, CCM published few fraudulent cases, offenders' names with the amount they penalized and imprisonment time. Most of the directors and secretaries were found guilty in unauthorized use of company property, making false statements to the CCM, gaining benefits for themselves, offering illegal investment and withdrawing company's funds without approval (CCM, 2012).

Malaysian SMEs are family concentrated companies, where most of the SMEs are run by families themselves with concentrated ownership (Claessens *et al*, 2000). Many Malaysian SMEs are family owned and controlled by the majority shareholder. Most of these companies are inherited by their own children. Numerous studies has been carried out on the majority shareholders and expropriations of minority shareholders' rights in Malaysia

(Himmelberg *et al*, 2004; Ahmed & Seet, 2009; Abidin *et al*, 2009; Chong, 2012). Nevertheless, Malaysia is a different case with respect to agency problem; here agency problem occurs between majority and minority shareholders. Indeed, Lai (2004), mentioned that the agency problem in Malaysian firms arise between the majority and minority shareholders. In such case, majority shareholders have the power of control over minority shareholders (Claessens *et al*, 2002; Morck *et al*, 1998).

Ownership concentration, fraudulent activities of majority shareholders, illegal investment schemes and other issues discussed, are the major barriers in the development of Malaysian SMEs. Although, these issues have indicated that, Malaysian SMEs have failed to follow instructions from CCM and other regulatory authorities for better corporate performance. Due to these issues, 50 percent of the SMEs collapsed during their first five years of operations (Khalique *et al*, 2011) and also the failure rate of Malaysian SMEs is quite high, approximately 60 percent (Ahmed & Seet, 2009). The Malaysian government is working to reduce the SMEs failure rate by providing different programs, such as the establishment of SME bank in 2005 was one of the initiative to cope with this problem. Furthermore, other programs were also undertaken to curb this issue, such as; enhancing productivity and quality through modernization and automation of machinery, promoting and increasing production efficiency, product development, encouraging SMEs to start R&D programs, and creating more conducive business environment of SMEs (Bank Negara Malaysia, 2006). Kiggundu (2002), finds that, the reason behind the failure of many SMEs is due to lack of competencies among the business owners, also lack of skills and abilities among the people holding management positions (Longenecker *et al*, 1999). Moreover, there is no corporate governance code for the Malaysian SMEs, which supposed to control firms.

CONCLUSION

In Malaysia, SMEs are the major contributor the country's GDPAs and also it has a good share in the employment sector. Malaysian government is working for the betterment of the SMEs, as they introduced ninth Malaysia plan. Not only that, the SME Corp is also found and involved in the policy making and taking robust steps to strengthen the Malaysian SMEs. Instead of that, it can be seen that, the Malaysian code for corporate governance put their positive mark on the public listed companies. Public listed companies are directed to perform according to the corporate governance code. Hence, they are performing better as compared to the SMEs.

Malaysian SMEs are family controlled and having concentrated ownership. It allows majority shareholder to expropriate the minority shareholders rights. Similarly, they appoint theirs kin and close friends on the board of directors and also on the management positions. This allows them to expropriate shareholders rights. As there is no corporate governance code available form to control SMEs and their ownership in Malaysia. Finally it is concluded that, Malaysian government should take necessary actions to cope with these issues in Malaysian SMEs.

References

Johnson, Simon, Boone, Peter, Breach, Alasdair, Friedman, Eric, 2000. Corporate governance in the Asian financial crisis. Journal of Financial Economics 58 (1–2), 141–186.

Glaeser, Edward, Johnson, Simon, Shleifer, Andrei, 2001. Coase versus the Coasians. Quarterly Journal of Economics CXVI (3), 853–900.

Bank Negara Malaysia. (2006). Small and medium enterprise (SME) annual report 2005: status and performance of SMEs.

National SME Development Council. (2006). SME annual report 2006.

Ndubisi, N.O. (2008), Small and Medium Enterprises in the Pacific Rim, Arah Publications, Kuala Lumpur.

Rachagan, S., & Satkunasingam, E. (2009). Improving corporate governance of SMEs in emerging economies: a Malaysian experience. *Journal of Enterprise Information Management, 22*(4), 468-484.

SME Corp Malaysia. (2012-13). SME annual report.

Claessens, S., Djankov, S., & Lang, L. H. P. (2000). The separation of ownership and control in East Asian Corporations. *Journal of Financial Economics, 58*(1–2), 81-112.

Thillainathan, R. (1999), "A review of corporate governance in Malaysia", Banker's Journal, Vol. 23, p. 43.

Nam, S.-W. A. D. B. I. (2001). Business groups looted by controlling families, and the Asian crisis.

Himmelberg, C.P., Hubbard, R.G. and Love, I. (2004), "Investor protection, ownership and investment", World Bank policy research working paper No. 2834, Washington, DC.

Claessens, S., Djankov, S., Fan, J. P. H. and Lang, L. H. P. (1999) "Corporate Diversification in East Asia: The Role of Ultimate Ownership and Group Affiliation", The World Bank, Working Paper.

Claessens, S., Djankov, S., Fan, J., & Lang, L. H. P. (2002). Disentangling the incentive and nentrenchment effects of large shareholders. *Journal of Finance, LVII*(6), 2741-2771.

Khatri, Y., Leruth, L. and Piesse, J. (2002) "Corporate Performance and Governance: A Stochastic Frontier Approach to Measuring and Explaining Inefficiency in the Malaysian Corporate Sector", International Monetary Fund Working Paper, pp. 1–26.

Ibrahim, H., & Samad, F. A. (2011). Corporate Governance Mechanisms and Performance of Public-Listed Family-Ownership in Malaysia. *International Journal of Economics and Finance, 3*(1), 105-115.

Wan-Hussin, W. N., 2005, The Effects of Owners' Participation and Lockup on IPO Underpricing in Malaysia, Asian Academy of Management Journal 10(1), 19-36.

Young, S. B. (2002) "Family Businesses and Reforms in Corporate Governance", The Caux Round Table.

Shleifer, A. & Vishny, R. W. (1997) A Survey of Corporate Governance, *The Journal of Finance,* vol 2, pp.737-783.

Dahya, J., Dimitrov, O., & McConnell, J. J. (2008). Dominant shareholders, corporate boards, and corporate value: A cross-country analysis. *Journal of Financial Economics, 87*(1), 73-100.

Porta, R. L., Lopez-de-Silanes, F., & Shleifer, A. (1999). Corporate Ownership around the World. *The Journal of Finance, 54*(2), 471-517.

Morck, R., Stangeland, D., Yeung, B. (1998). Inherited Wealth, Corporate Control and Economic Growth: The Canadian Disease. NBER Working Paper 6814. National Bureau of Economic Research.

Lins, K. V. (2003). Equity Ownership and Firm Value in Emerging Markets. *The Journal of Financial and Quantitative Analysis, 38*(1), 159-184.

Qian, M., Pan, H., & Yeung, B. Y. (2010). Expropriation of Minority Shareholders in Politically Connected Firms. *SSRN eLibrary*.

Anderson, R. C., & Reeb, D. M. (2003). Founding-Family Ownership and Firm Performance: Evidence from the S&P 500. *The Journal of Finance, 58*(3), 1301-1328.

Bennedsen, M., Nielsen, K. M., Perez-Gonzalez, F., & Wolfenzon, D. (2007). Inside the family firm: the role of families in succession decisions and performance. *Quarterly Journal of Economics, 122*(2), 647(646).

Cronqvist, H., & Nilsson, M. (2003). Agency Costs of Controlling Minority Shareholders. *The Journal of Financial and Quantitative Analysis, 38*(4), 695-719.

Maury, B. (2006). Family ownership and firm performance: Empirical evidence from Western European corporations. *Journal of Corporate Finance, 12*(2), 321-341.

Perez-Gonzalez, F. (2006). Inherited Control and Firm Performance. *The American Economic Review, 96*(5), 1559-1588.

Morck, R., Yeung, B. (2003). Agency problems in large family business groups. *Entrepreneurship, Theory and Practice, Summer*, 367-382.

Silva, F., & Majluf, N. (2008). Does family ownership shape performance outcomes? *Journal of Business Research, 61*(6), 609-614.

Longenecker, C. O., Simonetti, J. L., & Sharkey, T. W. (1999). Why organizations fail: the view from the front-line. *Management Decision, 37*(6), 503-513.

Companies Commision of Malaysia, 2012 *Annual Report - 2012*

Wahab, E. A. A., How, J. C. Y., & Verhoeven, P. (2007). The Impact of the Malaysian Code on Corporate Governance: Compliance, Institutional Investors and Stock Performance. Journal of Contemporary Accounting & Economics, 3(2), 106-129.

Ahmad, N. H., & Seet, P.-S. (2009). Dissecting Behaviours Associated with Business Failure: A Qualitative Study of SME Owners in Malaysia and Austraila. *Asian Social Science, 5*(9), 98-104.

Faccio, M., & Lang, L. (2002). The ultimate ownership of wetern European corporations. *journal of Financial Economics, 65*, 365-395.

Mohd Hassan Che, H., Rashidah Abdul, R., & Mahenthiran, S. (2008). Corporate governance, transparency and performance of Malaysian companies. *Managerial Auditing Journal, 23*(8), 744-778.

Abidin, Z. Z., Kamal, N. M., & Jusoff, K. (2009). Board Structure and Corporate Performance in Malaysia. *International Journal of Economics and Finance, 1*(1), 150-164.

Chong, W. T. (2012). Critical success factors for small and medium enterprises: perceptions of enterpreneurs in urban Malaysia. *Journal of Business and Policy Research, 7*(4), 204-215.

Lai, Y. H. (2004) "Corporate Governance in Malaysia: the Underlying Chinese Business Culture", DBA Candidate, University of South Australia.

Khalique, M., Md. Isa, A. H., Shaari, J. A. N. & Ageel, A. 2011. Challenges Faced By The Small And Medium Enterprises (Smes) In Malaysia:An Intellectual Capital Perspective. *International Journal of Current Research*, 3, 398-401.

Kiggundu, M. N. (2002). Entrepreneurs and entrepreneurship in Africa: What is known and what needs to be done. *Journal of Developmental Entrepreneurship, 7*(3), 239-258.