Accounting, Finance, Sustainability, Governance & Fraud: Theory and Application

Intan Marzita Saidon
Roshima Said *Editors*

Ethics, Governance and Risk Management in Organizations

Accounting, Finance, Sustainability, Governance & Fraud: Theory and Application

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Intan Marzita Saidon · Roshima Said
Editors

Ethics, Governance and Risk Management in Organizations

Editors
Intan Marzita Saidon
Faculty of Accountancy
Universiti Teknologi MARA (UiTM) Kedah
Merbok, Malaysia

Roshima Said
Research Management Unit
Universiti Teknologi MARA (UiTM) Kedah
Merbok, Malaysia

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Intan Marzita Saidon
Roshima Said

Introduction

Ethics, Governance and Risk Management: The Three Pillars of Organizations

Organizations around the globe have long been pressured with various issues such as globalization, the uncertainties of the market and increase in expectations of customers. This host of issues exposes organizations to various kinds of challenges, and thus the issues need to be tackled wisely, strategically and cost-effectively. Failure to do so may cripple the expected performance of the organizations and in some extreme cases render the organization obsolete.

Recently, the Fourth Industrial Revolution (IR 4.0) has brought along new challenges and opportunities to all organizations. IR 4.0 enables the integration of digital information from many sources. For instance, the Internet of things (IoT), cloud computing, artificial intelligence and robots enable organizations to do business beyond the ordinary level and boundaries. Productivity could be enhanced through optimization and automation. Ability to assess real-time data enables businesses to conduct real-time monitoring and more accurate forecasting. All these elements allow organizations to conduct their businesses in a more timely and efficient manner. However, one should always remember that with a great opportunity comes great challenges. The Internet of things (IoT) will enable systems, machines and human capital in and outside organizations to be interconnected with very limited boundaries. As such, in this new era of IR 4.0, organizations need to be careful in applying all those offered by the digital edge. They are forced to adjust, adapt and align their business models strategically to the fast-changing technological trends in order to remain relevant in today's market and survive in future.

Regardless of the size and level of technological advancement employed in conducting businesses, sustaining and nurturing social competency among employees remain as a significant agenda in any organizations. Social competence could be simply described as the ability to motivate each other, understand different points of view and manage a number of different character types and emotions. Managing human capital in an effective manner would be an important source to

nurture social competency in organizations. Human capital management is a skill needed to manage humane factor which is a foundation of teamwork in any organizations. Even in the era where technological advancement such as artificial intelligence (AI) and robotic process automation play an important role in doing business, human capital will remain as one of the critical success factors to any organizations. As mentioned in the literature, human capital is considered as a productive and not costly asset (Hendricks, 2002).

Besides having rules and regulations in managing their human capital, instilling a good ethical climate is one of the common ways employed by organizations to ensure that all employees are directed towards the right expected path in doing business. Indeed, little evidence is found to support the effectiveness of rule enforcement in handling unethical behaviour in organizations (Sackett & DeVore, 2002). The ethical climate is a concept which refers to the perceptions of employees on the extent of the organization's commitment in relation to ethical issues towards its employees and management. A perception of having a positive or good ethical climate may shape employees to display expected ethical behaviour. On the other hand, having a negative ethical climate may stimulate a higher tendency for moral deficiencies and unethical behaviour to grow among employees (Tsalikis & Fritzsche, 1989). Although organizational ethical climate tends to differ from one organization to another (Victor & Cullen, 1988), it is empirically proven that organizational ethical climate may modify personal values, attitudes and behaviours of members in organizations (Fang, 2006) as well as facilitate both positive and negative organizational outcomes (Martin & Cullen, 2006; Saidon, 2012). Moreover, there is growing evidence that organizations without an ethical compass will be left adrift in a sea of ethical dilemmas in doing business (ERC, 2007).

Good ethical climate alone is not enough to allow organizations to function at its best. The next important factor that needs to be considered in any organizations is to have a solid foundation to guide its operation. This foundation is commonly known as corporate governance. Corporate governance refers to the structures and processes by which organizations are directed and controlled. It helps an organization to operate more efficiently and safeguard against mismanagement. Corporate governance helps to protect relationships between management, shareholders and stakeholders in the sense that organizations need to be accountable and transparent to all the parties. In other words, corporate governance entails rules and regulations in order to ensure that organizations are governed in a transparent and accountable manner. Previous studies have shown that investors have greater confidence in organizations with good corporate governance (Das, 2014) and corporate governance could help improve firm's value and operating performance (Bhat, Yan, Jebran, & Bhutto, 2018; Black, Jang, & Kim, 2006).

The occurrences of corporate scandal cases like Enron and WorldCom that reverberated across the globe have refocused the public's attention and concerns about the need to have effective corporate governance. As for Malaysia, the introduction of the Malaysian Code of Corporate Governance (MCCG) in 2000 indicates a serious concern towards instilling and sustaining good governance among companies operating in Malaysia. This code was further reviewed in 2007

and 2012 in order to ensure its relevancy and alignment with globally recognized best practices and standards. Although this code is designed for listed companies, other companies such as state-owned enterprises, small and medium enterprises (SMEs) and licensed intermediaries are encouraged to adapt the code in order to enhance their accountability, transparency and sustainability.

Intense and escalating expectations of stakeholders as to how organizations should operate ethically and abide by the governance have somehow forced organizations to find ways to improve their classical ways of managing their businesses. As a result, nowadays, among the renewed focus in any organizations is how good they are in managing risks because the risk is the main cause of uncertainty in any organization. Risk can be described as the potential for unwanted negative consequences that arise from an event or activity (Rowe, 1980). Therefore, in order to excel, ability to accurately identify risks and manage them before they can even affect the business becomes one of the critical success factors in managing organizations. Early knowledge of the potential risks faced by organizations enables them to find various options on how to deal with the risks beforehand. Further, the ability to manage risk will help organizations act more confidently on making future business decisions.

Basically, there are two sources of risks faced by organizations: external and internal risks. The external risks refer to those risks which are beyond the direct control of the management. A few common examples are issues related to politics, exchange rates and interest rates. On the other hand, internal risks commonly relate to non-compliance issues and information breaches. Regardless of the sources, risks that potentially provide a negative effect on the organizations should be identified as critical risks. The critical risks should be handled in effective manners. It is worth noting that risk management is not a process of eliminating risks. The whole goal of risk management is to make sure that the organization only takes the risks that will help it achieve its primary objectives while keeping all other risks under control so that it could maximize opportunities and minimize possible threats.

The three aforementioned elements: ethical climate, corporate governance and risk management resemble to be the main pillars of organizations. Good ethics, strong corporate governance and effective risk management act as a solid foundation in moulding a successful organization. They are an integral part of ensuring the long-term survival of organizations. Acknowledging the importance of these three elements, this book provides a platform for scholars and researchers with various backgrounds and interdisciplinary expertise to showcase their research work and ideas pertaining to the three elements.

Intan Marzita Saidon
Roshima Said

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Editors and Contributors

About the Editors

Intan Marzita Saidon is Senior Lecturer at the Faculty of Accountancy, Universiti Teknologi MARA (UiTM), Kedah, Malaysia. She has more than twenty years of teaching experience in various accounting courses in UiTM. She obtained her first degree from Northumbria University, UK, and holds a Ph.D. degree from Curtin University, Australia. She is an Associate Member of the Malaysian Institute of Accountants. Her present research interests include ethics, strategic management and accounting education.

Roshima Said (Ph.D.) is a Professor of Universiti Teknologi MARA, Malaysia. Her research interests are in the area of corporate governance, corporate social responsibility, ethics and financial criminology. She has conducted a number of researches that were presented at international and national seminars and conferences and published in proceedings and journals. She also has published books and chapters both nationally and internationally. She is one of the Editorial Advisory Boards for the Social Responsibility Journal published by Emerald Group Publishing Limited. She also acts as Members of Board in Issues in Social and Environmental Accounting (Issues in SEA), Advisory Board of Emerald Book Series on Developments in Corporate Governance and Responsibility and Editorial Board Member of Journal of Corporate Responsibility and Governance. She also has been awarded "Outstanding Author Contribution Award Winner" by Emerald Literati Network Awards for Excellence 2012. In the year 2016, she has been awarded "Diamond Award" for the idea and product innovation by The 3rd International Innovation, Design and Articulation (i-IDeA 2016).

Contributors

Nadzri Ab Ghani Universiti Teknologi MARA (UiTM) Kedah, Merbok, Malaysia

Zakaria Abas Universiti Utara Malaysia, Changlun, Malaysia

Khilmy Abd Rahim Universiti Utara Malaysia, Changlun, Malaysia

Mas Aida Abd Rahim Universiti Teknologi MARA (UiTM) Kedah, Merbok, Malaysia

Reza Aminosharei University of Malaya, Kuala Lumpur, Malaysia

Noor Afza Amran Universiti Utara Malaysia, Changlun, Malaysia

Azyyati Anuar Universiti Teknologi MARA (UiTM) Kedah, Merbok, Malaysia

Manroshan Singh Bhatt University of Malaya, Kuala Lumpur, Malaysia

Corina Joseph Universiti Teknologi MARA (UiTM) Sarawak, Kota Samarahan, Malaysia

Zuria Juhari MSU College Sabah, Kota Kinabalu, Malaysia

Khairul Anuar Kamarudin Universiti Teknologi MARA (UiTM) Kedah, Merbok, Malaysia

Merve Kılıç Independent Researcher, Samsun, Turkey

Cemil Kuzey Arthur J. Bauernfeind College of Business, Murray State University, Murray, KY, USA

Norizah Mohd Mustamil University of Malaya, Kuala Lumpur, Malaysia

Usama Najam University of Malaya, Kuala Lumpur, Malaysia

Rafisah Mat Radzi Universiti Sains Malaysia, Minden, Pulau Pinang, Malaysia

Daing Maruak Sadek Universiti Teknologi MARA (UiTM) Kedah, Merbok, Malaysia

Intan Marzita Saidon Universiti Teknologi MARA (UiTM) Kedah, Merbok, Malaysia

Shahrina Liza Salisi Universiti Teknologi MARA (UiTM) Sabah, Kota Kinabalu, Malaysia

Muhammad Arief Siddiq Md Daud University of Malaya, Kuala Lumpur, Malaysia

Wan Adibah Wan Ismail Universiti Teknologi MARA (UiTM) Kedah, Merbok, Malaysia

Kim Mun Wong University of Malaya, Kuala Lumpur, Malaysia

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Part I
Ethical Issues in Organizations

How Does Organizational Ethical Climate Affect Interpersonal Deviance? The Role of Moral Disengagement

Intan Marzita Saidon and Nadzri Ab Ghani

Introduction

Workplace deviance is a pervasive problem experienced by organizations around the globe (El Akremi, Vandenberghe, & Camerman, 2010; Ferguson & Barry, 2011). For instance, in one particular study, three out of every four employees reported having stolen at least once from their employers (Appelbaum, Deguire, & Lay, 2005). In an academic world, a more recent study reported that workload and work pressure are significantly related to interpersonal deviance among academicians (Adeoti, Shamsudin, & Yen Wan, 2017). In a similar vein, a study on employees working in service sector organizations in Pakistan reveals that workplace ostracism, defensive silence, and emotional exhaustion lead to the prevalence of interpersonal deviance (Jahanzeb & Fatima, 2017). Generally, deviant behavior could harm organizations in many ways such as stimulate inhibition among employees and disrupt goal achievement (Porath & Pearson, 2010; Spector et al., 2006). Deviant behavior is reported to cost American organizations around 6 billion to 200 billion dollars per year (Diefendorff & Mehta, 2007; El Akremi et al., 2010).

In Malaysia, the setting of this study, no official statistic reports the impact of workplace deviance on businesses. However, bribery, absenteeism, industrial accidents, and poor work attitude are among the common forms of deviance reported in local newspapers and other media, indicating the occurrence of such behaviors among the Malaysian workforce. The Social Security Organisation (SOCSO), the Malaysian Labour Department, and the National Institute of Occupational Safety and Health (NIOSH) have admitted to having received reports on various deviant behaviors among employees (Abdul Rahim & Mohd Nasurdin, 2008; SOCSO, 2007). In fact, Malaysia Industrial Law Reports confirm the existence of various deviant behaviors among employees in Malaysia (Abdul Rahim & Mohd Nasurdin 2008).

I. M. Saidon (✉) · N. Ab Ghani
Universiti Teknologi MARA (UiTM) Kedah, Merbok, Malaysia
e-mail: i.marzita@uitm.edu.my

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Robinson and Bennet (1995) define workplace deviance as a voluntary behavior that violates significant organizational norms and, in doing so, threatens the well-being of the organization or its members, or both. Workplace deviance is commonly categorized in the literature as interpersonal and organizational deviance (Bennett & Robinson, 2000). Interpersonal deviance encompasses deviant behaviors such as stealing and verbal abuse targeted toward individuals within organizations, whereas organizational deviance refers to deviant behaviors targeted toward organizations, for example, intentionally taking extra time to complete tasks.

This study focuses on interpersonal deviance because such behaviors have direct detrimental effects on members within an organization which eventually affects the organization as a whole (Ferguson & Barry, 2011). For example, victims of interpersonal deviance were claimed to have experienced general and mental stress (Vartia, 2001). This reduction in the psychological well-being of the victims may negatively affect their job attitudes such as job satisfaction and commitment (Hershcovis & Barling, 2010). In turn, this may result in a reduction of their work effort (Porath & Pearson, 2010). If this is not controlled in the long run, organizations may have serious problems in maintaining quality and productivity because interpersonal deviance is significantly associated with turnover intentions (Hershcovis & Barling, 2010).

Undoubtedly, ethical codes of conduct and enforcement of rules have been the common methods applied to create a good ethical climate within organizations (Chonko, Wotruba, & Loe, 2002). However, the effectiveness of these methods is still inconclusive (Kaptein & Schwartz, 2008; Sackett & DeVore, 2002). Only 35% of studies reported that codes are effective in deterring deviant behavior (Kaptein & Schwartz, 2008). In a more recent study, Kaptein (2011) highlights that quality of communication, the content of codes, and the embedding of codes by management are among the factors that could influence the effectiveness of a business code of ethics. Failure to provide adequate attention to these three factors could make codes counter-effective and lead to more observed unethical behavior in the workplace (Kaptein, 2011).

Realizing that ethical codes of conduct and rules enforcement might not be the only solution to reduce the occurrence of deviant behaviors within organizations, scholars are increasingly interested in examining the role of ethical climate. To date, scholars argue that organizational ethical climate makes a crucial contribution to employees' behaviors (Baskin, Vardaman, & Hancock, 2016; Deshpande & Joseph, 2009). Having a positive ethical climate helps to improve individual conduct within organizations (Sims, 1992; Trevino, 1992) because such a climate may lead to positive job attributes such as higher job satisfaction (Okpara & Wynn, 2008) and commitment (Holmgren, Hensing, & Dellve, 2010; Okpara & Wynn, 2008). On the other hand, an organization with a poor ethical climate is expected to face greater problems of workplace deviance since ethical climate and organization misbehavior are found to be related (Appelbaum et al., 2005; Peterson 2002a, b).

However, there is a dearth of research examining the underlying mechanism to explain the relationship between ethical climate and workplace deviance, specifically interpersonal deviance. Such research is important theoretically because it will help to reveal the actual factor behind such a relationship. Practically, investigating on

the plausible factors behind this relationship may have implication in constructing a positive ethical climate within organizations.

This study has a number of intended contributions. First, although the relationship between ethical climate and workplace outcomes is well documented in the literature, the majority of research has focused on pro-social outcomes such as job satisfaction (Okpara & Wynn, 2008; Wang & Hsieh, 2012) and work commitment (Holmgren et al., 2010; Okpara & Wynn, 2008). This study goes beyond this boundary by investigating interpersonal deviance as an outcome. Second, there is little empirical study design to explain the underlying mechanism behind such a relationship. To address this gap, this study examines moral disengagement as a mediator. According to social cognitive theory (Bandura, 1986), moral disengagement could explain ways in which people justify their actions in performing deviant acts (Bandura, 1986, 1990, 2002). Moral disengagement is a cognitive mechanism that could be used to deactivate an individual's self-regulatory function. Once it is deactivated, an individual will be freed from psychological feelings of discomfort when performing deviant behavior. Despite providing a promising explanation for deviant problems, no study thus far has specifically investigated moral disengagement as a mediator in the relationship between ethical climate and interpersonal deviance. As a result, this study provides empirical findings on the mediating role of moral disengagement in the relationship between ethical climate and interpersonal deviance. Third, although theoretical work on previous studies has highlighted the link between ethical climate and organization misbehavior, almost all studies were done in the Western contexts (Appelbaum et al., 2005; Peterson, 2002a, b). This study was expected to provide a new dimension of findings beyond the reported scope of Western contexts.

The remainder of this chapter is structured as follows. In the second section, a review of the literature, theoretical framework, and hypothesis development are presented. The third section describes the research method which includes participants and procedures of data collection, the measurements of the constructs as well as the analysis procedures. The forth section explains the results of this study. Finally, the fifth section discusses the findings of this study including theoretical and practical implications as well as limitations and direction for future research.

Literature Review and Hypotheses

Organizational Ethical Climate

Victor and Cullen (1987) introduced the concept of organizational ethical climate which refers to the perceptions of employees regarding the extent of the organization's commitment to ethical issues in relation to its employees and management. The organizational ethical climate tends to differ from one organization to another because the ethical climate is created by shared perceptions among employees regarding the ethical conditions in their organizations (Victor & Cullen, 1988). Perceptions

of employees could include various aspects such as organizations' practices, procedures, expected behaviors, and the way management handles ethical problems (Martin & Cullen, 2006).

Victor and Cullen (1987, 1988) introduced the theoretical typology of ethical climates based on two dimensions: the ethical criteria used for decision-making (egoism, benevolence, and principle) and the locus of analysis (individual, local, and cosmopolitan). Eventually, the nine theoretical ethical climate types were then developed by crossing the three criteria used for decision-making and the three loci of analysis. These nine climate types are known as self-interest (egoism–individual), company profit (egoism–local), efficiency (egoism–cosmopolitan), friendship (benevolence–individual), team interest (benevolence–local), social responsibility (benevolence–cosmopolitan), personal morality (principle–individual), company rules and procedures (principle–local), and laws and professional codes (principle–cosmopolitan).

Subsequently, Victor and Cullen (1988) applied the nine climate types to develop an ethical climate questionnaire (ECQ). Using ECQ, Victor and Cullen (1988) identified ethical climate to consist of five types: caring, rules, law and code, independence, and instrumental. In 1993, Cullen et al. (1993) introduced a revised version of ECQ which has a total of 36 items. Subsequent researchers using ECQ have empirically reported seven to nine theoretical climate types (Cullen et al., 1993; Fritzsche, 2000). Likewise, Peterson (2002b) compared five studies that used 36-item ECQ and concluded that all the studies failed to reach an agreement on the number of ethical climate items that exist within organizations.

Organizational Ethical Climate—A Controversial Construct

A recent controversial issue regarding ethical climate construct is about the level of analysis. Some scholars argue that ethical climate should be measured at the organizational level because the definition of ethical climate given by Victor and Cullen (1987) reflects a group-level construct. As a result, scholars claimed that organizational ethical climate differs from the psychological ethical climate which refers to the ethical atmosphere experienced by an individual employee (Wang & Hsieh, 2012). In a similar vein, Glick (1985) and Kozlowski and Klein (2000) stress that psychological and organizational ethical climates are conceptually related but differ from each other. Therefore, advocates to this view suggest that the organizational ethical climate construct should be measured by aggregating the psychological climate of employees from the same organizations (Wang & Hsieh, 2012).

However, an intensive review of the literature revealed that most of the previous ethical climate studies used individual employees' perceived psychological climate to represent a construct of ethical climate (DeConinck, 2010; Kang, Stewart, & Kim, 2011; Martin & Cullen, 2006). In other words, the ethical climate is measured at an individual level of analysis and not at an organizational level. Furthermore, a meta-analysis concerning organizational safety climate (another sub-climate in an

organization) study revealed that more than 80% of the studies measured organizational safety climate at an individual level (Clarke, 2006). Therefore, in considering the ethical climate in this study, the representation of this construct by individuals (individual level of analysis) is deemed appropriate.

Organizational Ethical Climate and Interpersonal Deviance

The significant influence of organizational ethical climate on behavior in various contexts such as large organizations (Kang et al., 2011), education (Shapira-Lishchinsky & Rosenblatt, 2010), marketing (DeConinck, 2010), and accounting (Shafer, 2008) is well established in the literature. A classical view that "organizations are social actors responsible for the ethical or unethical behaviors of their employees" (Victor & Cullen, 1988, p. 101) could be used as a basis to describe the link between organizational ethical climate and behavior.

The literature demonstrates that organizational ethical climate has a significant influence on employees' ethical behavior (Deshpande, George, & Joseph, 2000; Fritzsche, 2000). In climates that emphasize ethical values and behavior, more ethical behavior is expected to exist (Wimbush & Shepard, 1994). The organizational ethical climate could help to shape and guide organizational members' behaviors in the determination of right and wrong at work (Schneider, 1983). Further, unethical behavior is more likely to occur in organizations with climates that are neither clear nor ethical (Vardi, 2001). For example, Kurland (1995) finds that financial services agents working in organizations concerned with ethical practices are less likely to withhold information from clients in order to secure sales. According to Robinson and Bennet (1995), several behaviors which are considered deviant also could be considered unethical, since the only difference between these two types of behavior is that ethics concentrates on behavior that is right or wrong, based on justice, law, or other social guidelines, whereas deviance focuses on behavior that violates significant organizational norms.

Employees' behavior is strongly influenced by their organizations' value systems (Boye & Jones, 1997). As mentioned earlier, employees' perceptions of their organization's climate may affect their tendencies to behave ethically or unethically (Litzky, Eddleston, & Kidder, 2006). The literature has argued that perceptions of having a good ethical climate may indicate that employee expectations of their organizations are being met (Vardi, 2001). In short, perceptions of having a good ethical climate will generate more positive than negative work behaviors (Vardi & Wiener, 1996). Similarly, an organizational climate with a strong emphasis on ethical behavior is said to lead to less deviant behavior among employees (Peterson, 2002a). Therefore, the following hypothesis is offered to be tested:

Hypothesis 1: Positive organizational ethical climate is negatively associated with interpersonal deviance.

Moral Disengagement as a Mediator

Beyond testing a relationship between organizational ethical climate and interpersonal deviance, this study proposes that moral disengagement could be the underlying mechanism in this relationship.

The concept of moral disengagement (Bandura, 1999) is developed as an extension of social cognitive theory. This theory helps to explain why certain people are able to engage in inhumane conduct without apparent distress (Bandura, 1999, 2002). Furthermore, the theory proposed eight interrelated moral disengagement mechanisms which could be classified into three groups. An individual would use: (1) a disengagement mechanism that results from a cognitive reconstruction of behavior (moral justification, euphemistic labeling, and advantageous comparison); (2) a disengagement mechanism that obscures or minimizes an individual's active role in damaging behavior (displacement of responsibility, diffusion of responsibility, and disregarding or distorting the consequences); and (3) a disengagement mechanism which focuses on the unfavorable traits of those to whom the harm is being perpetuated (dehumanization and attribution of blame).

The first group of disengagement mechanisms helps individual to justify their detrimental conduct, which is not considered by them to be immoral (Bandura, 1986). The basic assumption within this mechanism is that individuals do not ordinarily engage in harmful conduct unless they have justified to themselves the morality of their actions (Bandura, 1999). These three disengagement mechanisms involve cognitive reconstruction of the behavior itself. Through the engagement of these mechanisms, detrimental conduct is made personally and socially acceptable by displaying the conduct which is morally justified.

The second disengagement group helps to distribute blame across members of a group rather than placing blame on an individual (Bandura, 1999). Individuals are more likely to disengage their moral control if they can pass the responsibility of their actions to other parties or circumstances, such as management orders or peer pressure. With the displacement of responsibility, a common remark may be made by an employee in an organization: "I was made to do it by my boss." In relation to the diffusion of responsibility, responsibility is diffused in a situation where many people are involved in the wrongdoing. Individual responsibility is reduced as many others are also involved in the reprehensible conduct. In other words, when everybody is responsible then nobody is liable.

Finally, the last group results from minimizing the outcomes of the deviant conduct or minimizing the perception of distress that the conduct may cause to others (Bandura, 1990). Disregarding or distorting the harmful consequences of one's actions can further weaken one's own moral control. According to Bandura (2002, p. 108), "as long as the harmful result of one's conduct is ignored, minimized, distorted or disbelieved there is little reason for self-censure to be activated." Bandura (2002) further explains that harming others will be easier if the suffering is not visible and where the damaging actions are physically and temporarily distant from the injurious effects, as these conditions may prevent self-censure to function as a self-restrained.

To date, employees' cognition has been hypothesized as an important factor that should be considered in gaining a further understanding of the relationship between situational factors and workplace deviance (Lee & Allen, 2002). They further assert that employees' cognitive factors, such as thoughts about job features or perceptions of workplace justice, play an equal or greater part in shaping either helpful or harmful behavior of employees. In a similar vein, Moore (2008) argues that moral disengagement plays an important role in the process of organizational corruption.

In addition, Barsky (2011) revealed that the two mechanisms of moral disengagement (moral justification and displacement of responsibility) were significantly related to unethical behavior. The work by Barsky (2011) together with the work by Moore (2008) paved the way to integrate the concept of moral disengagement in investigating issues relating to organizational contexts.

Based on an intensive review of the literature, this study posits that the relationship between organizational ethical climate and interpersonal deviance is partly influenced by a particular cognitive aspect of employees, namely moral disengagement. When employees perceive that they are working in organizations which uphold ethical values and have a good ethical climate, they may have a lesser tendency to morally disengage and therefore are less likely to perform deviant behavior. Hence, this study proposes the following hypothesis:

Hypothesis 2: Moral disengagement mediates the relationship between positive organizational ethical climate and interpersonal deviance.

Method

Participants and Procedures

Large electrical and electronic manufacturing companies have been selected as the sample in this study because this sector is the largest employment provider in Malaysia (FMM, 2008). The electrical and electronic industry is obviously a major contributor to the Malaysian economy. Moreover, a previous study has shown that large organizations have more incidences of deviant behavior (Lau, Au, & Ho, 2002). Thus, given its importance to Malaysia, the electrical and electronic industry was deemed appropriate for this study.

In order to achieve an adequate response rate, 200 questionnaires were distributed to each of 15 randomly selected large electrical and electronic companies, from a total of 81 which are listed in the Federation of Malaysian Manufacturers (FMM) directory. Thus, a total of 3000 surveys were distributed using a drop-off and collect method to employees in the production departments of these randomly selected companies.

Of the 3000 surveys, 753 were returned, which is equivalent to a 25.1% response rate. However, 81 surveys were found to have more than 25% of unanswered items

and 3 surveys were excluded because the respondents gave the same responses to all the questions in the survey, resulting in an effective sample of 669 usable completed surveys (a 22.3% usable response rate). This response rate is considered sufficient because the rate is within the common range of response rates reported in business ethics research (Randall & Gibson, 1990). In addition, the sample size of 669 is adequate to provide a precise and reliable analysis when applying structural equation modeling (Boomsma & Hoogland, 2001).

Demographic statistics reveal that 69% of the respondents were female. The respondents were mainly Malay (82%), followed by Indian (11%) and Chinese (7%), with an average age of 31 years. More than half of the respondents (63%) worked as operators in the production department, and the remainder worked as production officers (12%), technicians (12%), supervisors (8%), or engineers (6%), with 21% having experience within the workforce for more than 10 years. Only 10% of the total respondents had first-degree qualification. The other 90% had a diploma, a certificate, or other qualifications.

Measures

Given the fact that respondents are from Malaysia and little research using the specified measures has been conducted outside of Western countries, a rigorous back-translation process was used to minimize potential variance due to cultural and linguistic differences. Since there were no discrepancies between the original and back-translated versions, the measurements in this study were considered to have meaning equivalence and were valid to utilize (Weeks, Swerissen, & Belfrage, 2007).

The organizational ethical climate was measured based on a scale used by Schwepker (2001). This scale was chosen because it is unidimensional and reasonably short, has been widely used, and has been shown to have acceptable reliability and validity. Respondents were asked to indicate on a 6-point Likert scale, ranging from 1 (strongly disagree) to 6 (strongly agree), the extent to which they agreed with the statements describing the existence of an ethical climate in their firm. Sample items are "my company has a formal, written code of ethics" and "my company strictly enforces a code of ethics." The reliability of this scale is $\alpha = 0.86$.

The 32-item scale used in multiple studies by Bandura and others (Bandura, 2002; Detert, Treviño, & Sweitzer, 2008; Hymel & Bonanno, 2014) was adapted to measure the moral disengagement of employees in this study. Moral disengagement was determined from eight subscales corresponding with the eight interrelated moral disengagement mechanisms. Since Bandura's scale was developed for use with children and young adolescents, the wording of the scale used in this study was adapted to reflect adult language as well as organizational circumstances. Sample statements are "it is alright to fight to protect your colleagues" and "an employee who only suggests breaking the rules should not be blamed if other employees go ahead and do it." The reliability of the adapted scale is $\alpha = 0.75$. Respondents were asked to

rate their agreement or disagreement with the statements given on a 6-point Likert scale, ranging from 1 (strongly disagree) to 6 (strongly agree).

Seven items from an interpersonal deviance scale by Bennett and Robinson (2000) have been utilized to measure interpersonal deviance construct. Sample statements are “made fun of someone at work” and “acted rudely toward someone at work.” The reliability of the scale is $\alpha = 0.83$. Respondents were asked to indicate, on a 6-point scale ranging from 1 (never) to 6 (daily), the extent to which they had engaged in each of the behaviors in the previous year.

Analysis

A non-response bias was checked by using Armstrong and Overton (1977) method of comparing responses of late respondents with those of early respondents on key demographic variables. For this analysis, the early respondents (62% of the sample) were compared with late respondents (38% of the sample) using an independent sample t-test. A comparison between early and late respondents revealed no significant difference for key demographic variables: age of respondents, work experience, firm size, gender, and language proficiency. Therefore, the evidence suggested that the responses of those surveyed were typical of the larger population.

As for common method bias, this study relied on Harman’s single-factor test (Podsakoff & Organ, 1986). An unrotated factor analysis of all variables yielded 3 factors in total, explaining 77% of the variance. This analysis demonstrates that a single-factor solution does not emerge, thus offering evidence that this type of bias is not a likely concern in this study.

The covariance-based structural equation modeling (SEM) software analysis of moment structures (AMOS) was applied to test the hypotheses. This study applied two-stage modeling by first developing the measurement model (CFA), before proceeding to test the hypotheses using the structural model (Anderson & Gerbing, 1988). The measurement (CFA) and structural models were evaluated by using five absolute fit indices (Joreskog & Sorbom, 1981): χ^2 goodness-of-fit statistic, goodness-of-fit index (GFI), comparative fit index (CFI), Tucker-Lewis index (TLI), and root-mean-square error of approximation (RMSEA). As for the GFI, CFI, and TLI, values greater than 0.90 were acceptable, whereas for RMSEA a value equal to, or smaller than, 0.08 was deemed acceptable (Byrne, 2001).

Results

Means, standard deviations, and correlations of this study are shown in Table 1. Construct reliability (Bagozzi, 1980) and average variance extracted (Fornell & Larcker, 1981) were calculated to further confirm the reliability of the measures. For each of the constructs, the construct reliability and average variance extracted

Table 1 Means (M), standard deviations (SD), reliability and correlations between constructs

Constructs	M	SD	α	Construct reliability	Average variance extracted	1	2	3
1. Organizational ethical climate	3.66	1.65	0.86	0.80	0.50			
2. Moral disengagement	2.64	0.59	0.75	0.94	0.50	−.419**		
3. Interpersonal deviance	2.25	1.21	0.83	0.83	0.50	−.364**	.411**	

Note **$p < .01$

met the minimum benchmark of 0.60 and 0.50, respectively (Bagozzi & Yi, 1988). The bivariate correlations between the constructs were all in the predicted direction and were found to be significant at $p < 0.01$. Most respondents were not highly prone to morally disengage, as indicated by the mean (2.64) and standard deviation (0.59) for moral disengagement, which was assessed on a 6-point Likert scale. A mean of 3.66 for organizational ethical climate assessed on a 6-point Likert scale indicated that respondents did not strongly perceive that they were working in a good ethical climate. As for interpersonal deviance construct, the mean of 2.25 indicated a low frequency of interpersonal deviance committed by respondents. However, the standard deviation of 1.21 suggested a reasonably high variability in the respondents' willingness to declare their deviant behaviors.

Three structural models (Table 2) were compared in order to determine the mediating role of moral disengagement in the relationship between organizational ethical climate and interpersonal deviance. First, the direct effect model (M1) was compared with the fully mediated model (M2). Both models provided an acceptable fit to the data. Against the direct effect model (M1), the fully mediated model showed a significant change in chi-square ($\Delta\chi^2$) at $p < .001$ indicating that the fully mediated model (M2) was a better fit compared to the direct effect model (M1). Then, the fully mediated model (M2) was compared with the partial mediation model (M3). An examination of goodness-of-fit indices showed that the partial mediation model (M3) had a better fit ($\chi^2 = 101.90$, df = 33, $p = .000$). Although the chi-square statistic for the partial mediation model was statistically significant, this is not deemed unusual given the large sample size (Bagozzi, Yi, & Phillips, 1991). The change in chi-square ($\Delta\chi^2$) between the fully mediated model (M2) and partially mediated model (M3) was significant at $p < .001$. Further, the GFI was .971, CFI = .989, TLI = .985, and RMSEA = .056. Taking all results together, the partial mediation model (M3) was concluded to be the best fit model. Thus, all hypotheses were assessed based on this model (M3).

In support of hypothesis 1, which proposed that organizational ethical climate is negatively associated with moral disengagement, the path coefficient ($\beta = -.43, p < .001$) was negative and significant. To confirm hypothesis 2, that moral disengagement mediates the relationship between organizational ethical climate and interpersonal deviance, the bootstrapping method with 1000 bootstrap re-sampling

Table 2 Fit indices and comparison of alternative models

Model	Type	$\chi 2$	df	GFI	CFI	TLI	RMSEA	$\Delta \chi 2$(df) Sig	Comparison
Direct effect	M1	292.83	35	.929	.958	.946	.105		
Fully mediated	M2	147.58	34	.959	.981	.975	.071	145.25 (1)***	M1–M2
Partial mediation	M3	101.90	33	.971	.989	.985	.056	45.68 (1)***	M2–M3

Note ***$p < .001$

and bias-corrected confidence intervals was utilized (Preacher & Hayes, 2008). The bootstrapping analysis indicated that the indirect effect of organizational ethical climate on interpersonal deviance via moral disengagement was significant (indirect effect = −.094, 95% lower bootstrap CI = −.129, upper CI = −.062, $p < .01$). Thus, hypothesis 2 was supported. Moral disengagement is found to partially mediate the relationship between organizational ethical climate and interpersonal deviance.

Discussion

The objectives of this study were to empirically test the relationship between organizational ethical climate and interpersonal deviance and to evaluate the effect of organizational ethical climate on interpersonal deviance through moral disengagement. Based on social cognitive theory, this study hypothesized that moral disengagement plays a mediation role in the relationship between organizational ethical climate and interpersonal deviance. Results supported all hypothesized relationships.

Consistent with the claim that fostering a positive ethical climate may encourage sound business practices (Mulki, Jaramillo, & Locander, 2008), organizational ethical climate was found to have a negative significant relationship with interpersonal deviance. The result does not only corroborate previous studies in the Western context, which find that organizational ethical climate is negative and significantly related to organizational misbehavior (Appelbaum et al., 2005), but also provide further support on the notion that organizational ethical climate is an important factor that may influence ethical behavior of employees (Wimbush & Shepard, 1994). In other words, the findings of this study indicate that organizational ethical climate which reflects employees' shared beliefs and values of the organization might help to shape and guide employees' behavior, including their determination of right and wrong at work. Working in a positive ethical climate could discourage employees to act deviantly because such climate might signal required ethical standards for employees to function effectively in their organizations.

More interestingly, this study provides evidence that moral disengagement appears to be the underlying mechanism in the relationship between organizational ethical climate and interpersonal deviance. From a theoretical perspective, these findings indicate that employees' perceptions of their organizational ethical climate could influence their self-regulatory functions, particularly their decision to morally disengage. Having a negative perception of their organizational ethical climate might deplete the strength of employees' self-regulatory functions. Employees then may decide to deactivate their self-regulatory functions through moral disengagement which, in turn, functions to facilitate their deviant behaviors. Thus, moral disengagement helps to undermine employees' psychological feelings of discomfort when performing interpersonal deviance. Moral disengagement was proved to be a mechanism through which the relationship between organizational ethical climate and interpersonal deviance occurs. These findings are aligned with the claim made by Bandura et al. (1996) and Johnson (2014) that moral disengagement is a way to

justify deviant conduct. Previously, Detert et al. (2008) and Moore (2008) revealed that moral disengagement mediated the relationship between individual differences and unethical decision-making in organizational contexts.

Given that organizations are currently undergoing many transformations which will consequently result in less control over employee behavior (Babiak, Neumann, & Hare, 2010), the findings of this study provide a valuable contribution in terms of providing insights regarding the relationship between organizational ethical climate and interpersonal deviance. In summary, this study contributes to the literature by providing not only empirical evidence of the significant negative relationship between organizational ethical climate and interpersonal deviance in a non-Western context, particularly Malaysia, but also the evidence regarding the plausibility of moral disengagement as the underlying mechanism in such relationship.

Theoretical and Practical Implications

There are several theoretical and practical implications worth noting from the current findings. In terms of theoretical contribution, although the link between organizational ethical climate and organizational misbehavior is well documented in the literature, there has been far less research conducted in the non-Western context. It should not be assumed that findings derived from the Western data could be generalized to other regions of the world, such s Asia, particularly Malaysia. Thus, findings in this study added to and extended the literature beyond the reported scope of Western countries.

The application of social cognitive theory, particularly moral disengagement, has, so far, been neglected in explaining interpersonal deviance in organizations. Thus, the significant mediated relationship suggested that moral disengagement could partly facilitate the occurrence of interpersonal deviance in manufacturing companies in Malaysia. This study showed that an indirect relationship also could possibly occur via employees' moral disengagement. The findings provide further evidence that moral disengagement is a transnational concept to be applied in justifying deviant acts. This is consistent with the claim that "people do not ordinarily engage in reprehensible conduct until they have justified to themselves the rightness of their actions" (Bandura et al., 1996: p. 335).

In terms of the practical implications of this study, organizations need to be more judicious in creating their ethical climate. Failure to create a positive ethical climate could somehow encourage employees to morally disengage, which might consequently help the employees to perform deviant acts without any psychological feeling of discomfort. To address this issue, organizations may need to revisit their relevant policies and procedures that are specifically related to behavioral governance in order to assure that a positive ethical climate is perceived by all employees. Organizations may assess their ethical climate periodically in order to monitor their climate.

Finally, it is also critical for organizations to ensure that ethical standards are clearly communicated to employees. Clear ethical standards help employees to objectively assess the ethical climate within their organizations. The expectations of top management and efforts related to ethical issues in the organizations need to be made known to all levels of employees through appropriate cultural communication systems. Organizations should realize that ethical climate could positively influence the moral thinking of employees, thus helping them to become socially responsible corporate citizens.

Limitations and Directions for Future Research

There are limitations that need to be recognized in interpreting the findings. First, this study is conducive to socially desirable responses. However, several preventive steps were taken to minimize social desirability bias, such as guaranteed anonymity and confidentiality of individual responses, and the use of some reverse-scored items. Secondly, the moral disengagement scale applied was previously designed and validated only in samples of children and young adolescents in Western countries. Therefore, it is possible that there may be some potential setbacks when applying this measure to an adult sample in a non-Western country such as Malaysia. However, the rigorous back-translation process was used to carefully adapt and tailor the sample of this study to accommodate this concern. Finally, the sample of this study was derived from the Federation of Malaysian Manufacturers (FMM) directory and thus excluded companies that are not listed in the directory. Consequently, generalizations from the findings of this study to all manufacturing companies in Malaysia cannot be made.

Future research could develop a general scale of moral disengagement to cater especially for an organizational setting in non-Western countries, as this would assist in engaging a new avenue of research. A mixed-method approach (Creswell, 2009) could also be applied in order to get better insights into the relationship between organizational ethical climate and interpersonal deviance. Finally, replication of this study in the future using samples from other sectors or cultures could be a fruitful attempt to confirm a robust conclusion of the findings.

Conclusion

In summary, workplace deviance is a pervasive problem which is costly to organizations and could negatively affect employees' well-being. Results suggest that moral disengagement could be the underlying explanation in the relationship between organizational ethical climate and interpersonal deviance. Thus, understanding moral disengagement among employees and creating a positive ethical climate could be a way to control the occurrence of interpersonal deviance at the workplace.

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Intan Marzita Saidon is a senior lecturer at the Faculty of Accountancy, Universiti Teknologi MARA (UiTM), Kedah, Malaysia. She has more than twenty years of experience in teaching various accounting courses in UiTM. She obtained her first degree from Northumbria University, UK, and holds a Ph.D. degree from Curtin University, Australia. She is an associate member of the Malaysian Institute of Accountants. Her present research interests include ethics, management accounting, supply chain management and accounting education.

Nadzri Ab Ghani is a senior lecturer at the Faculty of Accountancy, Universiti Teknologi MARA (UiTM), Kedah, Malaysia. He has been with UiTM for more than fifteen years, and before joining UiTM he was a lecturer at Institut Teknologi Tun Abdul Razak, Malaysia. He holds a Ph.D. in corporate governance (specifically in the area of whistle-blowing) from Curtin University, Australia. He is an active researcher, and his research interests include whistle-blowing, supply chain management, and accounting education.

Servant Leader and Ethical Climate: An Integrative Approach to Employee Ethical Behavior

Norizah Mohd Mustamil and Usama Najam

Introduction

> Leaders set the tone for their peers.
>
> Peers look up to them and say, 'They're doing it, so I'm doing it.'
>
> —Chris Bosh

The above quotation provides a broad idea on the importance of a leader, as the most significant role in setting up behavior among others in an organization. Generally, individuals working in an organization learn the way of doing things by observing the norms and practices in their surroundings. Leaders' actions and decision will always be observed and taken as a signal to indicate the culture and climate of the organization. In addition, many empirical studies have testified the impact of leadership style on individuals' attitudes and behavior. Overall, studies in the management area have addressed the influence of transformational and transactional leadership styles on individual outcomes. In the context of ethics, however, the focus needs to be given to the servant leadership style which is more relevant in explaining the influence of leadership style on ethical behavior.

Brown and Bryant (2015) have argued that the servant leadership style promotes an ethical culture more than any other leadership styles. A servant leader through his persona and example-setting attitude becomes the role model to his followers, especially in dealing with employee ethical behavior at the workplace. Referring to existing studies on servant leadership style, this area still remains as a largely unexplored area. There are less studies in exploring servant leadership style as an antecedent factor of employee ethical behavior. This gap may due to the fact that an individual's ethical behavior has proven to be very challenging due to the multitude of complex and varied factors that contribute to this behavior. As a result, most of

N. Mohd Mustamil (✉) · U. Najam
University of Malaya, Kuala Lumpur, Malaysia
e-mail: norizahmm@um.edu.my

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the studies are focused more on individual-level factors which include demographic profile, ethical ideologies, and personal values and personalities on ethical decisions. This scenario, however, has led to a question about the influence of leadership style toward ethical behavior and more specifically on how the leadership style establishes a foundation for the ethical climate which encourages employee's ethical intention when dealing with ethical dilemmas in a workplace.

Therefore, the main focus of this chapter is to uncover the servant leadership's latent ethical side and explain how an ethical servant leader promotes ethical behavior among his or her followers by providing an ethical climate in the organization.

What Is Ethical Behavior?

Generally, ethical behavior is referred to good action and decision which follow certain standards including rules and regulation. Furthermore, it is characterized by moral values including honesty, fairness, transparency, and integrity. Modrak (1986) explains Aristotle's philosophical viewpoint that ethical behavior is related to what should and should not be done with regard to how a person perceives certain behavior as a 'good' or 'bad' action. As a result, it leads to a doctrine that ethics is very subjective and depends on an individual's standard, which is fundamentally based on two schools of thought: Deontology and Teleology.

According to Kant (1980), deontologists perceived that ethical behavior follows universal law and people should act based on their duty. Therefore, 'don't lie' and 'don't cheat' are the accepted rules in defining the ethical standard. On the other hand, teleologists are consequentialists who perceived ethical standards should be based on the outcomes of the action. The more beneficial and good consequences an act produces means the more right is that action.

In the context of the workplace, deontological and teleological perspectives have established employees' beliefs (duty or outcomes), once they enter their workplace. However, what is happening in a workplace might not be aligned with this belief. As a result, it creates a conflict to employees, especially when they are facing ethical dilemmas. Below is a scenario to describe the conflict.

> Scenario 1: Zulkifli was newly appointed as a sales executive in company A, a manufacturer of personal computers. He is very excited with the offer and eager to start his career with company A. Zulkifli is a person who believes that people should behave according to universal law. He obeys rules and regulations; and believes that a person has a duty to perform a good action. Therefore, good values such as respect, honesty, transparency and integrity should not be compromised. After two months in company A, Zulkifli realized that his principle is at stake and found that it is challenging to implement his beliefs in the workplace. His job requires him to give empty promises to his customers, to entertain potential customers and to bribe existing clients with luxury gifts and entertainment. Zulkifli is in a dilemma: He is aware of the wrongdoings which contradict to what he firmly believes. However, he also knows that he needs to continue with these practices to keep his job and enhance his career. He is not sure of what should be done.

The above scenario is a daily scenario that happens in a workplace, which confirms a complex situation faced by an employee, like Zulkifli. Jones (1991) in his study has confirmed that individual in a workplace has more challenging tasks in defining ethical standard due to the fact that the environment in a workplace might oppose to his or her beliefs, which is essential in determining the way one behaves at the workplace. Nevertheless, the theory of socialization process Van Maanen and Schein (1977) explains that an employee will realign his or her system of beliefs within the organizational setting. Therefore, in the context of Zulkifli, the inconsistency in his ethical beliefs will be adjusted and modified according to the ethical practices at the workplace. As a result, there are tendencies that Zulkifli might engage himself in these malpractices as these practices are considered as norms in company A although they are contrary to his beliefs. Douglas, Davidson, and Schwartz (2001) in their study confirmed that individuals at a workplace tend to fine-tune their internal values which derived from their moral philosophies in sharing the common values among others. In addition, a modification can also be performed based on what they observe from their leaders. In other words, if the leader behaves ethically and avoids any wrongdoings, they will tend to perform or imitate such behavior and vice versa. This process is an ongoing process which explains the relationship between the ethical leader, ethical climate, and ethical behavior.

Leader with Ethics: The Player

Social learning theory and social exchange theory explain that a leader plays a role in shaping the behavior of his followers. The employees working under a leader will follow him or her when they feel secure regarding their own beliefs. Similarly, the social exchange theory says that if any organization wants to develop ethical climate in the organization, the organization must identify a fair, caring, and an honest leader. Ethical climate in the organization can be created by a leader who takes care of the others' interests and promotes their well-being (Hinkin & Schriesheim, 2015).

According to the Path–Goal Theory of leadership, leaders are responsible for setting goals, guiding subordinates' paths to achieve goals, and attaching rewards on subordinates' success in fulfilling assigned goals. The Expectancy Theory by Vroom and Yetton (1973) also posits that an employee's behavior in achieving certain goals depends on his expectancy to achieve it, as well as the valence outcome in achieving such goals.

The leadership studies conducted by several Ohio State University behavior theorists claim that a leader uses two distinct styles to motivate employee behaviors, one is initiating structures' style and the other, consideration style (Hemphill & Coons, 1957). This style is also known as the instrumental leadership. In this style, a leader involves in a directive style while setting goals, and later provides guidance in achieving the goals. These leaders motivate the employees using the reward system as they achieved the expected performance. On the other hand, the second style that is the consideration style of leadership is also known as the participative

or supportive leadership. A leader who follows this style creates an environment for people orientation, where people come first. These leaders psychologically support their followers by providing friendly environment, whereas the instrumental leader draws focus on the implementation of rules and standard in guiding the employees to cope with potential conflicts which may arise because of ethical dilemmas.

It is evident from the leadership literature that organizational leaders are basically responsible for influencing, creating, and managing the culture and climate of the organization. This notion is also supported by Çavuş and Develi (2017) that a leader's attitude, intentions, and behaviors are crucial for creating an ethical climate in the organization. Victor and Cullen (1988) defined ethical climate as the work dimensions that explain what establishes ethical conduct at the workplace. To form an ethical climate, Victor and Cullen (1988) argued that along with an employee's personal perceptions and beliefs about the ethical values, he also relies on the cues from his or her leaders and colleagues. Several studies have examined issues related to ethics and salespeople. Murphy (2005) pointed out that having explicit ethical guidelines can reduce unethical behaviors among sales employees.

Leader makes decisions by keeping into account the interest of others. Ethical climate restricts deviant behaviors of employees in the organization. As the social learning theory says that a leader is the role model for his followers; so, when the leader himself follows rule, code, and laws, then his followers will also behave in a same manner. For this reason, it is necessary to have ethical leadership which promotes ethical climate in organizations. Ethical climate has relationships with extra role behaviors. Kanungo (2001) disputed that ethical leaders avoid the acts which could harm others and show only behaviors that are proven to be ethical. When an organizational manager is honest and just, he or she will nurture and instill those ethical norms in the employees. Both social exchange theory and social learning theory support this fact. Mulki, Jaramillo, and Locander (2009) contended that leaders play an important role in creating ethical climate in the organization.

Fundamentally, ethical leadership means behaving in a right manner and respecting the prestige of others (Ciulla, 2005). Researchers have increased interest in ethical leadership during past decades (Hunter et al., 2013). Researchers have invested a lot of time and effort in exploring the benefits of ethical leadership. As every leader of any organization has social power, the main concentration of ethical leadership is the fact that whether leaders do ethical use of their social power in decision making (Velasquez, Andre, Shanks, & Meyer, 1987). If the leadership is ethical, it would be more effective and victorious. In their everyday actions, behaviors, and undertakings, leaders should ethically conduct and use normative standards in all activities. Many philosophers and religious reviewers have argued that if any leader wants to achieve successful governance, ethics must be his/her first priority. Kanungo (2001) stressed that ethical leaders avoid those acts which harm others and show only those behaviors which are proven to be ethical. Ethical leadership is thought to be the topic of immense potential for the researchers.

In general, Yang and Wei (2017) suggested ethical leadership can be considered as suitable behavior by using interpersonal relationships and distinctive actions. Brown and Treviño (2006) posited that ethical leadership as "the demonstration

of normatively appropriate conduct through personal actions and interpersonal relationships, and the promotion of such conducts to followers through two-way communication, reinforcement and decision-making" (p. 120). Ciulla (2005) argued that when people ask about leadership, they ask "what is ethical leadership?" so it is crucial to emphasize the ethical dimension of leadership. In other words, the efficiency of a leader is not enough to determine good leadership; a leader must also be ethical in his everyday activities.

Ethical leadership is about managing ethics by continuously following and promoting ethical conduct and embracing everyone responsible for this in the organization (Brown & Treviño, 2006). Treviño et al. (2000) conducted an interview with managers and executives of an organization and found two dimensions of the ethical leadership which are (1) moral managers and (2) moral persons. A moral manager is a person who leads the behaviors of others in an ethical domain, whereas moral person is characterized by a person's own ethical nature, truthfulness, honesty, integrity, and good character. Mayer, Kuenzi, and Greenbaum (2010) suggested that a moral manager is a unique facet of ethical leadership construct. Treviño, Hartman, and Brown suggested the matrix of four different types of leaderships which are: (1) unethical leadership which comprises weak moral person and weak moral manager, (2) hypocritical leadership which comprises weak moral person but strong moral manager, (3) ethical leadership which has strong moral person as well as strong moral manager, and (4) silent or neutral leadership which has strong or weak moral person and weak moral manager.

Additionally, "moral persons" is the perception of others about the fairness, honesty, integrity, personal traits, attributes, and the characteristics of the leader (Brown and Treviño 2006). The other dimension of ethical leadership is "moral manager" which means that the leader keeps ethics into account and encourages other employees to be honest (Brown, Treviño, & Harrison, 2005). Ethical leader shows morality in personal as well as professional life and as moral manager, a leader influences ethical conducts at workplace (Brown et al., 2005). This feature distinguishes the proactive attempts through which leaders affect the companions' behaviors and moral views about the ethics. Moral managers always give the message of ethics to the followers. They usually use mechanism of reinforcement (i.e., discipline and rewards) and make followers responsible for their decisions and deeds.

Servant Leadership Is Ethical Leadership

For most of us, the words servant and leader are two extremes mainly because a leader has been described and comprehended as a person who holds certain management position and has the authority to give orders and leads people. Contrary to this, a servant is a person who is supposed to execute orders and serve others. Then, what are good leaders made of? The fundamental reason of a leader's existence is his priority to serve the community by leading a team which works under him and not

merely ruling or commanding over people (Smith, 2005). This is the core point from where the need for servant leadership emerges which starts with "I serve and that's why I lead" mentality.

According to Carter and Baghurst (2014), servant leadership is a unique approach of leading through serving. It is a novel philosophy that is steadily gaining attention from practitioners and scholars. The trend of servant leadership is driven by the growing need for a leader who does not seek power and self-interest. While leadership in general is considered as a mean of influencing employees by directing and motivating them to achieve organization goals, servant leadership in contrast takes a winding road by first, seeking to serve the interest of the employees, then the goals of the organization.

Chan and Mak (2014) claimed that literature shows a correlation exists between a servant leader, employee attitudes, and commitment toward ethical behavior. Mitterer (2018) proposed that servant leadership provides opportunities for employees to learn and grow by sharing power. It helps employees achieve their potential by increasing individual self-confidence. According to the social learning theory, individual learns by modeling the attitude and behaviors of the role model, so when a leader exhibits a servant behavior, it will be mirrored by employees as they think the leader to be altruistic and authentic.

Vallesi et al. (2005) explain that with the passage of time, various leadership styles and theories have emerged and adopted, but the core objective and purpose of these theories, as comprehended, remained focused which is to rule people toward the attainment of a common goal. Seyal and Abd Rahman (2014) argued that popular leadership styles like charismatic and transformational leadership styles remained focused on inspiring followers and keeping them engaged, whereas servant leadership solely focused on an individual's growth and development.

Although the idea of servant leadership dates its existence some thousands of years back in history, this theory caught attention and immense importance in 1970 with the publication of 'The Servant as Leader' by Robert Greenleaf, which tossed the concept of servant leaders. Greenleaf believed that a leader who characterizes servant attributes is driven by a natural feeling of serving others, which then urges the individuals with the desire of leading people with the motive of serving their needs (Spears, 1996).

Previous literature and researches have shed light on the amalgamation of servant leadership and ethical leadership. These two leadership styles are not mutually exclusive, rather they complement each other. In a recent research by Jaramillo et al. (2015), they called servant leadership style as an ethical servant leadership and they used the multidimensional scale developed by Liden, Wayne, Zhao, and Henderson (2008). The research conducted by Reed, Vidaver-Cohen, and Colwell (2011) found that though transformational leadership, authentic leadership, and spiritual leadership have similarities with ethical leadership, they also differ in core dimensions of ethical leadership. For instance, the focus of transformational, authentic and spiritual leadership style lacks in establishing ethical standards and moral management, which is the prime focus of an ethical leader.

On the other hand, servant leadership is not different from ethical leadership rather it reinforces it. The dimensions which are lacking in the current servant leadership constructs with respect to ethics are sustainability and ethical guidance. These two dimensions, when combined, will define the ethical servant leadership. The amalgamation of these two leadership theories has a positive impact on creating a sustainable ethical climate for the organizations.

Dierendonck et al. (2011) identified eight important constructs related to effective leadership, which are empowerment, accountability, standing back, humility, authenticity, courage, forgiveness, and stewardship. Kalshoven et al. (2011) construed that the Ethical Leadership at Work (ELW) dimension of ethical construct majorly overlap with servant leadership construct except concern for sustainability and ethical guidance.

This chapter postulates the amalgamation of eight dimensions of servant leadership by Dierendonck et al. (2011) with two dimensions of ethical leadership from the ELW dimension to form an ethical servant leadership construct. This comprehensive model has a significant impact in creating a sustainable, ethical climate in today's business world.

The amalgamation of ethical leadership with servant leadership leads to the discovery of how it impacts the employees' ethical behavior in the workplace. In addition, the mediating effect of ethical climate is also discovered. This study sheds light on how an ethical servant leader creates a better environment for employees, by being a role model for them to behave ethically and becoming more prone toward performing ethical behaviors.

Servant Leadership in Developing an Ethical Climate

The concept of ethical climate is similar to the concept of work climate or organizational culture but considerably concentrates on the organizational activities and policies. Shin (2012) argued that ethical climate is a type of organizational work climate which shows normative organizational procedures and policies. There are various previous studies that evaluated the relationship between ethical climate and various work consequences. Relatively, little effort has been made to explore the factors affecting ethical climate.

According to De Coninck (2011), those people who work for the organizations that have an ethical environment are reported to have fewer turnover intentions, whereas Burton and Peachey (2014) mentioned that there are other benefits for the ethical organization which enable them to spend less on marketing and publicity. The benefits include that it builds customers' trust and has less effect of any negative press. As suggested by Arnaud and Sekerka (2010), ethical work climate (EWC) was the only framework which was used by 75% studies related to organizational ethical climate. Arnaud and Schminke (2012) who narrated this framework were later criticized where the main concern was whether the model is comprehensive enough to capture ethical climate dimensions.

Arnaud and Sekerka (2010) built the framework of Ethical Climate Index (ECI) with the help of three studies that include Victor and Cullen's (1988) and study of Rest (1984) as a foundation for the framework. The ECI framework consists of four components which are: collective moral sensitivity, collective moral judgment, collective moral motivation, and collective moral character. To briefly describe these components, the first one is related to the norms that exist in a social system which make us morally aware and develop some empathetic concerns inside us. The second component enables us to do reasoning between what is right and what is wrong and to judge our actions. The third component includes the values that exist in our social system. These values could be helping, being honest, and to be fair in our actions which can also include personal achievement, control over things, and the power you possess. The fourth component of the framework describes whether the person has the strength to choose the most ethical way when doing daily life decisions. Hence, the basic purpose of developing this framework was to determine organization's ethical environment in today's era.

As noted by Jaramillo et al. (2015), there is very less research that is done in the field of ethical work climate and servant leadership. In another study by Mulki et al. (2009), it was found that most of the salespeople who work under the leader with servant leadership characteristics are most likely to believe in themselves that their organization is operating on higher level of ethics and that they are willing to surpass normal standards of ethical conduct.

According to the study of Van Meter et al. (2013), students who have servant leadership traits are less likely to involve in any unethical activity as they believe it as a cheat and unacceptable. A similar study which was done by Burton, Peachey, and Wells (2017) on athletes found that servant leadership nurtures trust in people which brings ethical climate through procedural justice in the sports. Burton et al. (2017) further suggested the need of research to see if servant leaders can create positive work environments across a variety of different types of companies or organizations.

Jaramillo et al. (2015) highlighted servant leadership has proved its significance in previous researches regarding enhancing organization's ethical level, employees' organizational commitment, and turnover intention. Furthermore, it has also predicted additional variance above and beyond that of other leadership styles such as transformational leadership.

A servant leader expresses humility which aids in building a work atmosphere which promotes follower perception about safety and trust. Šumi and Mesner-Andolšek (2016) suggested that leaders who demonstrate humility help in creating a work environment in which followers perceive greater safety and trust, which results in followers by their own will perform organization tasks in a better committed way. If a servant leader follows the ethical norms and establishes ethical trends in the organization, it will lead to an ethical environment within the organization. Schwepker and Schultz (2015) explains servant leader is unlikely a transformational leader, believes in leading individuals by focusing on micro-behaviors of followers which then results into macro-behaviors which are significant to sustain organizational virtuousness.

Employees who are being nourished in a conducive ethical climate are keen toward developing behaviors which involve caring for others' interest and well-being, obeying rules, codes, and laws of that organization, and respecting others' personal beliefs. When employees work in such climate, they feel free to work as they feel internally secure. They feel motivated and committed toward their job. When employees are free to have their personal beliefs and feeling concerned for themselves, their customer service and task performance improved. Employees work in term of social exchange rather than economic exchange.

There are many empirical studies which provide evidences that positive behavior of the employees is generated by creating positive work climate. According to Çavus and Develi (2017), in today's organizations where pro-social and extra role behavior act as a crucial determinant of job performance, ethical servant leadership can be a fruitful source of such outcomes. The findings of Burton et al. (2017) showed that if the leader shows servant leadership characteristics, it will positively impact the ethical climate. The study found that most of the employees have chosen to work under ethical organizational leader. Both of servant leadership and modeling of ethical behavior could facilitate and retain those employees where these synergies resonate. When the directors of the department demonstrate the characteristics of servant leader at the department, employees describe the climate of the department as ethical. The result of this study is also supported with the study of Jaramillo et al. (2015) who found that most of the salespeople who worked under the leader who has the characteristics of a servant leader are most likely to believe in themselves that their organization is operating at the higher level of ethics and they are willing to surpass the normal standards of ethical conduct.

As narrated by Brown et al. (2005), by acting as an ethical role model and promoting the culture of encouragement and expectation leads to positivity of the ethical work environment. These findings are also in congruence with Bandura (1971) social learning theory that explains how leader becomes an ethical role model for his/her follower by exhibiting ethical behaviors and moral deciosn making at workplace. As argued by Brown et al., if the leader of the organization is consistent in making ethical decisions and acting upon moral values, the employees will tend to mimic the behavior of the leader.

Hence, it is important for the leader to be consistent in his ethical actions even if it is difficult. Burton and Peachey (2014) were of the view that employees get motivated and most likely to engage in ethical decision making and act in morally responsible way if the leader with servant leadership style is demonstrating ethical behavior consistently and solving issues within an ethical-driven environment.

Conclusion

This chapter highlighted the conceptual relationship between servant leadership, ethical climate, and ethical behavior in an organization. The servant leadership is an emerging paradigm potentially able to establish an ideal climate for ethics which

carry, instruct, and assist employees as organizational actors in behaving ethically. Their behaviors have a cascading effect on their employees following the company ethical code and standards, showing concern for other coworkers, customers, and stakeholders. Generally, the basic function of a leader is to influence followers. Particularly, the values, morals, and behaviors displayed by the leader send a message to the organizational climate, and this shapes the employees' action and decision. Therefore, servant leadership and ethical climate are crucial components in an integrative approach in producing ethical behavior among employees. This is true as the old saying used to describe the leader's influence in the organization, "if you're going to talk the talk, you've got to walk the walk."

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Norizah Mohd Mustamil is currently a senior lecturer at the Department of Business Policy and Business Strategy, Faculty of Business and Accounting, University of Malaya. She received her MBA from the University of Malaya and DBA from the Curtin University of Technology, Western Australia. Her research is interdisciplinary and addresses ethical issues in business practices and human resource management areas. Her current interest includes the antecedent factors of leadership styles on individuals' ethical behaviors in organizations. She has written several chapters in books and journal articles which have been published in journals including Journal of Organizational Change Management, Journal Management & Marketing, Journal of Family Business Management, and Journal of Entrepreneurship in Emerging Economies. She has several years of experience in consultancy projects with government and private agencies such as Ministry of Human Resources, Ministry of Education, National Population and Family Development Board, Institute of Labor Market Information and Analysis, National Co-operative Movement of Malaysia (ANGKASA), and National Academy of Arts, Culture and Heritage (ASWARA).

Usama Najam is currently a Ph.D. scholar at the Faculty of Business and Accountancy, University of Malaya. His Ph.D. research focuses on the servant leadership style and its consequences on employees. He has also worked as a lecturer at Air University, Pakistan, for 5 years. His research interests focus mainly on the areas of leadership, human resource management, and organizational behavior. In the last two years, he has published three articles in (impact factor) SSCI indexed journals such as Sustainability, South Asian Journal of Human Resource Management, and Cogent Business & Management. One of his publications also focuses on temporal leadership and its consequences on employee temporal diversity.

The Role of Ethical Reasoning in the Relationship Between Work Experience and Whistle-Blowing Intention

Nadzri Ab Ghani and Intan Marzita Saidon

Introduction

Recently, there are increased interests in examining individual key factors such as gender, age, and tenure that could possibly contribute to whistle-blowing intention (Gökco, 2013; Keil, Tiwana, Sainsbury, & Sneha, 2010). Yet, findings on the relationship between work experience and whistle-blowing intention from previous studies are still open for discussion (Lih-Bin & Hock-Hai, 2010; Rahayuningsih, 2016; Taylor & Curtis, 2010; Zhang, Chiu, & Li-Qun, 2009a, 2009b). Therefore, this study is an attempt to answer the call to further investigate the relationship between work experience and whistle-blowing intention (Miceli, Near, & Dworkin, 2008).

Scholars agree that adequate work experience is essential in determining an individual's decision to whistle-blow (Ab Ghani, Galbreath, & Evans, 2012; Mesmer-Magnus & Viswesvaran, 2005; Sims & Keenan, 1998). Work experience has been directly associated with whistle-blowing intention by many researchers, but this relationship has produced inconclusive empirical results (Miceli et al., 2008). Reviews from Miceli, Near and Dworkin (2008) and Mesmer-Magnus and Viswesvaran (2005) indicate that the inconclusive results range from a positive relationship (Brewer & Selden, 1998; Dworkin & Baucus, 1998; Goldman, 2001; Miceli & Near, 1988) to a mixed relationship (Wise, 1995) to an insignificant relationship (Keenan & Sims, 1995; Lee, Heilmann, & Near, 2004; Sims & Keenan, 1998).

Given this state of empirical findings, this study proposes a specific aspect to strengthen the relationship between work experience and whistle-blowing intention based on the argument that cognitive moral development is positively related to socially responsible behavior (Goolsby & Hunt, 1992). Since the cognitive aspect has been found to affect individuals' behavior, the relationship between work experience

N. Ab Ghani (✉) · I. M. Saidon
Universiti Teknologi MARA (UiTM) Kedah, Merbok, Malaysia
e-mail: nadzri.abghani@uitm.edu.my

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and whistle-blowing intention is predicted to be dependent on such cognitive aspects, specifically ethical reasoning.

The main objective of this study is to examine the mediating role of ethical reasoning upon the relationship between work experience and whistle-blowing intention. This effort is deemed significant in several ways. First, this study would offer an alternative explanation for the inconclusive empirical results obtained from previous studies on the direct effects between work experience and whistle-blowing intention. Second, as evidenced, only limited studies have investigated whistle-blowing intention in a non-Western context such as Malaysia (Lih-Bin & Hock-Hai, 2010; Park & Blenkinsopp, 2009; Zhang et al., 2009a, 2009b), and thus, the results of this study are expected to, at least, bridge Western and non-Western differences. Finally, this study may bring further insight regarding the influence of ethical reasoning on whistle-blowing intention, particularly within the manufacturing sector in Malaysia.

Theoretical Background and Hypotheses

Whistle-Blowing Intention

Whistle-blowing is defined as 'the disclosure by organization members (former or current) of illegal, immoral, or illegitimate practices under the control of their employers, to persons or organizations who may be able to effect action' (Near & Miceli, 1985, p. 4). Since the dependent construct of this study is whistle-blowing intention rather than actual whistle-blowing action, the issue of behavioral intention needs to be examined.

According to the theory of planned behavior (TPB) (Ajzen, 1991; Ajzen & Fishbein, 1985), 'behavioral intention is a good predictor of actual behavior' (Chiu, 2003, p. 66). A behavioral intention is a subjective probability that an individual assigns to the likelihood that a given behavioral alternative will be chosen (Ajzen, 1991; Hunt & Vitell, 1986). A person's behavioral intention is a weighted additive function of three elements, namely the person's attitude, subjective norm, and perceived behavioral control. According to Demetriadou (2003), the person's attitude is the person's judgment of that behavior, whereas the person's subjective norm means the person's perceived acceptability of that behavior and the person's perceived behavioral control refers to the person's perception of the difficulty level of performing that behavior.

The whistle-blowing intention in this study refers to 'the individual's probability of actually engaging in whistle-blowing behavior' (Chiu, 2002, p. 582). The decision to study whistle-blowing intention rather than actual whistle-blowing action is justified due to the impossibility and difficulty of carrying out investigations of unethical conduct in the workplace by first-hand observation (Victor, Trevino, & Shapiro, 1993). However, a study on restaurant employees in the fast-food industry provides

evidence that behavioral intention correlates with actual peer reporting of unethical behavior (Victor, Trevino, & Shapiro, 1991). Thus, examining whistle-blowing intention is deemed appropriate in the context of this study.

Ethical Reasoning

Ethical reasoning refers to an individual's ability to apply values and standards to socio-moral problems and determine a course of action (Sivanathan & Fekken, 2002). The psychology of ethical reasoning draws from the field of cognitive, moral development (CMD) theory put forward by Kohlberg (1969). According to Kohlberg (1981), CMD theory combines moral philosophy with cognitive psychology in making the assertion that an individual's cognitive development is a prerequisite for the individual's moral reasoning. Here, the terms ethical reasoning and moral reasoning are used interchangeably as commonly found in prior behavioral ethics research (Trevino, Weaver, & Reynolds, 2006).

In short, CMD theory is about the cognitive processes that the individual uses in making decisions between right and wrong that depend on the individual's level of ethical reasoning. The level of ethical reasoning (as listed in Table 1) will determine the individual's ethical reasoning ability (Herington & Weaven, 2008). CMD theory proposes that the level of an individual's ethical reasoning ability is closely linked to the individual's chosen action and the chosen action is likely to be more ethical as the level of ethical reasoning increases (Kohlberg, 1976). Ethical reasoning ability is measured by six different stages of CMD and is classified under three levels of

Table 1 Six stages of cognitive moral development

Pre-conventional level	
Stage 1	Obeying rules and authority, avoiding punishment, and not doing physical harm
Stage 2	Serving one's own or others' needs and making fair deals in terms of concrete exchange
Conventional level	
Stage 3	Playing a good (nice) role, being concerned about other people and their feelings, keeping loyalty and trust with partners, and being motivated to follow rules and expectations
Stage 4	Doing one's duty in society, upholding the social order, and maintaining the welfare of the society or the group
Post-conventional level	
Stage 5	Upholding the basic rights, values, and legal contracts of society, even when they conflict with the concrete rules and laws of the group
Stage 6	Assuming guidance by universal ethical principles that all humanity should follow

Source Adapted from Rest (1994)

moral development, namely pre-conventional, conventional, and post-conventional (Colby & Kohlberg, 1987).

To measure ethical reasoning ability, Kohlberg (1969) developed his own instrument called the Moral Judgment Interview (MJI). However, another instrument, the Defining Issues Test (DIT), is the most widely accepted instrument to measure ethical reasoning ability (Gibbs & Widaman, 1982; Goolsby & Hunt, 1992; Narvaez & Bock, 2002; Rest, 1986a; Rest, Naravaez, Thoma, & Bebeau, 1999). Rest (1979a) states that the DIT provides greater scoring reliability than the MJI. Recently, Narvaez and Bock (2002) claimed that the DIT overcomes issues related to the ability to articulate one's reasoning.

Work Experience and Ethical Reasoning

Work experience refers to the individual's length of time employed by his/her current employer or organization (Cherry, 2006). In line with CMD theory, Kohlberg's (1969) model of moral reasoning proposes that individuals develop their ability for ethical reasoning over time within a work environment (Forte, 2004). A study by Kujala (1995) proves this proposition where top managers with longer managerial experience have more positive attitudes toward ethical issues in relation to stakeholders. Further, in their review of ethical reasoning, O'Fallon and Butterfield (2005) believe work experience influences ethical decision making. Hence, the following hypothesis is proposed.

Hypothesis 1: Work experience is positively associated with ethical reasoning.

Ethical Reasoning and Whistle-Blowing Intention

Linking with the theory of planned behavior put forward by Ajzen (1991), Kohlberg's CMD theory (1981) proposes that individuals interpret their activities when planning, learning, and acting. Kohlberg (1981) believes individuals' morality can be determined by knowing their intentions and points of view. Such cognitive processes are subject to their attitudes, the subjective norm, and perceived behavioral control, under the theory of planned behavior (Ajzen, 1991). Besides, Rest's (1979a, 1994) model of ethical action theorizes that ethical reasoning consists of four components: (1) identification of an ethical dilemma, (2) ethical judgment, (3) intention to act ethically, and (4) ethical action or behavior (Jones, Massey, & Thorne, 2003). Many scholars agree that the ethical reasoning process is part of an individual's overall moral consciousness when dealing with difficult conflicts or dilemmas in everyday practice (Louwers, Ponemon, & Radtke, 1997). In agreement, Thorne (2000) states that several assumptions have been made by many researchers, based on the

theory, which proposes that individuals sequentially progress through stages in the development of ethical reasoning. Thus, the following hypothesis is proposed.

Hypothesis 2: Ethical reasoning is positively associated with whistle-blowing intention.

Ethical Reasoning as a Mediator Between Work Experience and Whistle-Blowing Intention

Drawing from the field of cognitive moral development, the psychology of moral reasoning provides a theory to explain an individual's decision-making process prior to ethical behavior. Cognitive moral development theory proposes that ethical reasoning develops 'as the individual develops, gaining experience and autonomy, and producing relationships that are based on mutual reciprocity giving rise to the emergence of subjective responsibility' (Izzo, 2000, p. 121). Such moral reasoning ability is not directly theorized as a mediator between work experience and whistle-blowing intention in the existing literature. However, ethical reasoning is widely regarded not only as a key benefit of work experience (Herington & Weaven, 2008; Izzo, 2000; Ponemon, 1995; Stewart & O'Leary, 2006), but also a significant antecedent of whistle-blowing intention (Brabeck, 1984; Liyanarachchi & Newdick, 2009; Xu & Ziegenfuss, 2008). Hence, the following hypothesis is proposed.

Hypothesis 3: Ethical reasoning mediates the relationship between work experience and whistle-blowing intention.

Methods

Sample and Procedure

This study uses large manufacturing companies listed under Bursa Malaysia Berhad (BMB) (formerly known as Kuala Lumpur Stock Exchange (KLSE), the stock-broking company in Malaysia). Large manufacturing companies refer to manufacturing companies having more than 1000 employees and market capitalization of RM500 million (BMB, 2018). Previous research has shown that large organizations have a greater incidence of wrongdoings (Lau et al. 2002). Manufacturing companies are posited as an adequate environment because such companies often incorporate incidents of wrongdoings (Hooks, Kaplan, & Schultz, 1994; Ponemon & Gabhart, 1994).

The rationale for choosing the companies under BMB is based on the provisions under the Malaysian whistle-blowing law, newly introduced in 2003 under the Securities Industry (Amendment) Act, 2003, and under the new Companies (Amendment) Act, 2007 (Hassan, 2006; Yakcob, 2005). It was reported that listed manufacturing companies under BMB are more likely to run investigations for whistle-blowing behavior (Anwar, 2003).

Supervisors were chosen as respondents in this study. The first reason for choosing supervisors is based on the argument that the reports of wrongdoings are usually made by members close to the inner workings of an organization (Mesmer-Magnus & Viswesvaran, 2005). Another reason is based on the argument made by Wahab (2003), who indicates that supervisors who intend to disclose their organization's malpractices will be protected from victimization and retaliation under the Securities Industry (Amendment) Act, 2003. Generally, the Malaysian whistle-blowing provisions apply to breaches of securities laws and stock exchange rules. However, Khan (2003) suggests that the issue of implementation of the Act should firstly be confined to specific employees such as supervisors of publicly listed companies.

Using the BMB directory, five companies from three sectors (consumer product, industrial product, and technology) were randomly selected to form a total of 15 companies for the sample of this study. A total of 600 surveys were distributed to all supervisors working in the selected 15 companies. Of the 600 surveys, 346 were returned, representing 57.7% response rate. However, 35 responses were discarded because they failed to meet reliability checks on ethical reasoning. The reliability check of ethical reasoning adhered to Rest's rules for consistency (Rest, 1986b). The DIT contains a reliability check called M score.

The M score, which refers to 'meaningless,' is an internal reliability check used by the researcher to detect non-thoughtful respondents (Herington & Weaven, 2008; Izzo, 2000). Thus, the M score items are not representative of any stage of thinking. Therefore, respondents who score too high for these items are considered to be unreliable respondents and as such are discarded from the dataset.

Further, a second built-in check on reliability is called the 'consistency check.' Each respondent's rating is compared with his/her rankings. It is expected that the rankings should correspond to the ratings. Therefore, if the rankings do not correspond to the ratings, those respondents are eliminated from the data. Thus, a total of 311 completed questionnaires were used for this study, representing 51.8% response rate. The response rate is deemed appropriate because Babbie (1986) suggests that a response rate of at least 50% is adequate for analysis and reporting, while 50–60% is good for research on a sensitive topic.

Also, non-response bias was checked (Armstrong & Overton, 1977) comparing responses of late respondents with those of the early respondents on key demographic variables. Independent sample t-tests revealed no significant differences between any of the variables, indicating non-response bias does not appear to be a problem with this study.

Measures

This study considers the fact that the respondents are Malaysians and little research has been conducted using the chosen measures in the non-Western context. Therefore, a back-translation process was utilized to minimize any possible variation due to cultural and linguistic differences.

The work experience was measured by asking respondents to indicate the length of their employment in their organization. The respondents stated the number of years for their length of employment (Mesmer-Magnus & Viswesvaran, 2005; Sims & Keenan, 1998). As for whistle-blowing intention, this construct was measured using a short scenario or vignette adapted from Demetriadou (2003). Vignettes are 'short descriptions of a person or social situation which contain a precise reference to what are thought to be the most important factors in the decision-making or judgment-making process of respondents' (Alexander & Becker, 1978, p. 94). The vignette approach was utilized in this study because the vignette provided a more realistic context for the respondents, i.e., they themselves are placed in the position of a character portrayed in a hypothetical situation (Patel, 2003; Reidenbach & Robin, 1990; Weber, 1992).

Along with the vignette, a four-item semantic differential scale of behavioral intention has been adapted from Barnett et al. (1996) and used to measure whistle-blowing intention. This scale was utilized because it displays a respondent's intention in a consistent manner for the given vignette (Barnett et al., 1996; Zhang et al., 2009a). The respondents were asked to read the vignette and assess the probability of blowing the whistle in both terms of 'given the hypothetical situation above, indicate your likelihood to report the observed violation to the next higher level' and 'given the hypothetical situation above, indicate your colleagues'/peers' likelihood to report the observed violation to the next higher level.' The purpose of asking the respondents to imagine their colleagues'/peers' behavioral intention was to identify any social desirability response bias that might be present in the response (Watkins & Cheung, 1995).

A six-point scale ranging from 6 (definitely would) to 1 (definitely would not) was used. The reliability of the scale was $\alpha = 0.965$. The rationale for applying the six-point scale was to overcome the central tendency error (Cooper & Schindler, 2003). This error could occur when respondents, especially in the Asian countries, ended up ranked their priority in the neutrality dimension (Trompenaars & Hampden-Turner, 1997). Therefore, the middle response, namely 'neutral' or 'neither would nor would not,' was excluded when designing the survey instrument.

The ethical reasoning was measured using the widely used short version of Rest's (1979a, 1979b) Defining Issues Test (DIT). The DIT was employed to measure the respondents' cognitive moral development levels (Colby & Kohlberg, 1987; Rest, 1986a). The DIT consists of a series of short, standardized vignettes relating to general social dilemmas (Herington & Weaven, 2008). The full version of the DIT contains six vignettes; however, this study utilizes a shorter version, i.e., a three-vignette version. This shorter version is popular among researchers, particularly

due to the response rates probability being compared to the longer version (Bay & Greenburg, 2001; Early & Kelly, 2004; Eynon, Hill, & Stevens, 1997; Goolsby & Hunt, 1992; Ho, Vitell, Barnes, & Desborde, 1997).

In addition, Herington and Weaven (2008) posit that there is a necessity to minimize cultural adaptation of ethical dilemma topics. Thus, the choice of social dilemmas for the three vignettes is based on the respondents' 'applicability to the environment', i.e., the Malaysian environment. The respondents were required to read the three dilemmas and answer a set of questions. After reading each dilemma, the respondents were asked to rank their top four (out of twelve) issue statements based on their level of importance.

The ethical reasoning score was determined based on the respondents' ranking of the four most important issue statements. More specifically, the score is known as P% score (standing for 'principled morality'). The P score represents the percentage of total possible scores (0–95) assigned to stages 5 and 6 issue statements (according to Kohlberg's cognitive moral development theory). According to Herington and Weaven (2008), an individual with a high P score possesses a high level of ethical reasoning ability, and this equates with ability to reason at a high stage of cognitive moral development.

Gender, educational level, and firm size were included as control variables. Gender was a dichotomous variable represented by male = 1 and female = 2. Educational level was measured using a nominal scale and was coded as a four-level variable: 1 (Diploma), 2 (Degree), 3 (Master's degree), and 4 (other qualification). Firm size was measured with a single item: number of full-time equivalent employees. The control variables had been proposed by Miceli and Near (1992) to be potential influences on whistle-blowing decisions (Barnett et al., 1996; Barton, 1995; Regh, Miceli, Near, & Van Scotter, 2008).

Analysis and Results

Table 2 displays the profile of the respondents. All information is presented in actual figures and percentages to facilitate interpretation. The proportion of males to females is 50.2% males and 49.8% females, with 63.7% of the respondents married and 36.3% single. The respondents are mainly Malay (63.0%), Chinese (21.9%), and Indian (15.1%) with 68.5% of them aged between 30 and 40 years. In total, 43.4% of the respondents have a university degree and 33.5% work in large companies having more than 2000 employees.

Means, standard deviations, and correlations are presented in Table 3. Overall, the correlations between the variables are in the predicted direction and significant at $p < 0.01$. Following the DIT manual (Rest, 1990), P scores of respondents fall into three categories; 'low third' category refers to P score 0–27%, 'middle third' category refers to P score 28–41%, and 'high third' category refers to 42–100%. The mean of ethical reasoning is 36, indicating that the sample of this study falls into the 'middle third' category. The 'middle third' category shows that the level of ethical

Table 2 Profile of respondents

Demographic profile	Number of respondents ($N = 311$)	Valid percentage (%)
Gender		
Male	156	50.2
Female	155	49.8
Marital status		
Single	113	36.3
Married	198	63.7
Race		
Malay	196	63.0
Chinese	68	21.9
Indian	47	15.1
Age		
<30	18	5.8
30–40	213	68.5
>40	80	25.7
Educational level		
Diploma	87	28.0
Degree	135	43.4
Master degree	19	6.1
Other qualification	70	22.5
Size of organization		
1000–1999	207	66.5
2000–2999	82	26.4
3000–3999	22	7.1
Working experience		
<5 years	94	30.2
5–10 years	102	32.8
>10 years	115	37.0

reasoning is concentrated on the conventional level (stages 3 and 4) of CMD theory (Kohlberg, 1969, 1981).

In brief, this level of ethical reasoning shows the respondents are able to resolve ethical dilemmas. The average work experience of the respondents was 8 years. In general, the respondents indicated a small tendency to whistle-blow as indicated by the mean of 3.8 assessed in the six-point Likert scale. The control variables are not correlated with the dependent variable in this study. Therefore, all control variables were predicted not to have any confounding effect on the hypothesized relationship, and the decision was made to exclude all control variables in subsequent analysis.

Table 3 Mean (M), standard deviation (SD), and correlation between the study variables

Variables	M	SD	1	2	3	4	5	6
Work experience	8.424	4.999	1.00	–	–	–	–	–
Whistle-blowing intention	3.846	1.786	.180**	1.00	–	–	–	–
Ethical reasoning	35.982	19.732	.949**	.205**	1.00	–	–	–
Gender			−.090	.023	−.092	1.00	–	–
Educational level			.168**	.003	.134*	−.117*	1.00	–
Firm size	1855	467.774	−.052	−.061	−.033	−.050	−.084	1.00

M, means; SD, standard deviations
*p < 0.05; **p < 0.01

Table 4 Regression results for Hypotheses 1 and 2

	Ethical reasoning				Whistle-blowing intention			
Predictors	R^2	$F_{(1309)}$	β	Sig	R^2	$F_{(1309)}$	β	Sig
Work experience	.291	126.85	.539	.000				
Ethical reasoning					.039	12.521	.197	.000

Note R^2 = R-square scores, F = F-ratio, β = Beta weights, Sig = level of significance (***p < .001)

Using regression analysis, as shown in Table 4, the results indicate a significant relationship between work experience and ethical reasoning ($F = 126.85, p < .001; \beta = .539, p < .001$). Thus, Hypothesis 1 is supported. Similarly, a significant relationship is found between ethical reasoning and whistle-blowing intention ($F = 12.521, p < .001; \beta = .197, p < .001$). Therefore, Hypothesis 2 is supported.

Hypothesis 3 proposes that ethical reasoning mediates the relationship between work experience and whistle-blowing intention. The common way to assess mediation is to apply the multi-step process suggested by Baron and Kenny (1986). However, recently, researchers have argued that mediation can be established without the significant direct relationship between independent and dependent variables (MacKinnon, Fairchild, & Fritz, 2007; MacKinnon, Lockwood, Hoffman, West, & Sheet, 2002; Shrout & Bolger, 2002). Therefore, this study applies the Sobel test (Sobel, 1982) to test mediation.

The Sobel test is a method for assessing indirect effects that, in itself, does not require significant main effects for the independent and dependent variables (MacKinnon et al., 2002, 2007). As shown in Table 5, the Sobel test statistic is significant at $p < .05$ ($z = 2.127, p = 0.03$). Thus, this study finds support for the mediating effect of ethical reasoning on the relationship between work experience and whistle-blowing intention. Hypothesis 3 is therefore confirmed.

Table 5 Result of Hypothesis 3

	Test statistics	Standard error	*p*-value
Sobel test	2.127	0.0125	0.03

Note $*p < .05$

Discussion

This study examines a direct relationship between work experience and whistle-blowing intention, and the mediating role of ethical reasoning on this relationship, with a sample of Malaysian supervisors in manufacturing companies. As stated by Abdullah (1996), although Malaysian society is a multi-cultural mix (Malay, Chinese, and Indian), Malaysian workers share common and distinct workplace values. Confirming Hypothesis 1, work experience has a positive relationship with ethical reasoning. This result is consistent with prior studies in a Western context (Izzo, 2000; Stewart & O'Leary, 2006). Similarly, for Hypothesis 2, ethical reasoning has a positive relationship with whistle-blowing intention, and thus, the result is consistent with prior studies (Gundlach, Douglas, & Martinko, 2003; Gundlach, Martinko, & Douglas, 2008). As for Hypothesis 3, the results show ethical reasoning plays a mediating role in the relationship between work experience and whistle-blowing intention.

The analysis proves that ethical reasoning links the relationship between work experience and whistle-blowing intention. Hence, more experienced supervisors are more likely to have whistle-blowing intention if they possess ethical reasoning ability. Theoretical, ethical reasoning ability is determined by the level of ethical reasoning. In this study, the level of ethical reasoning of Malaysian supervisors falls within the 'middle third' category. The 'middle third' category shows the level of ethical reasoning of the supervisors is concentrated on the conventional level (stages 3 and 4) of Kohlberg's (1969, 1981) model of cognitive moral development theory. Having this level of ethical reasoning, the supervisors are believed to be able to resolve ethical dilemmas without leading to any harm to others in their organizations.

Applying the theory of CMD and following Kujala (1995) and O'Fallon and Butterfield (2005), this study concludes that the more work experience supervisors gain, the greater the increase in their ethical reasoning abilities, and therefore, the more tendency they may whistle-blow. As mentioned by Miceli, et al. (2008), individuals' levels of work experience play a vital role in their decisions to whistle-blow. On the other hand, Liyanarachchi and Newdick (2009) suggest that individuals' decisions to whistle-blow depend upon their levels of ethical reasoning.

Theoretical and Practical Implications

This study makes three major contributions to theory. Firstly, as a preliminary study involving whistle-blowing in Malaysia, this study provides new literature on whistle-blowing research in a non-Western context. Thus, the results of this study may additionally provide literature in comparing whistle-blowing behavior between Western and non-Western countries. Previously, a study using large companies indicates that American managers are more likely to whistle-blow compared to Chinese managers (Keenan, 2007). Secondly, this study demonstrates a direct relationship between work experience and whistle-blowing intention, which advances previous empirical research. Lastly, this study suggests a new avenue to whistle-blowing research by incorporating ethical reasoning as a mediating variable in strengthening the relationship between work experience and whistle-blowing intention.

In terms of the practical implication of this study, the findings indicate that top management would gain from supervisors who can be relied upon to receive whistle-blowing complaints from workers (Mesmer-Magnus & Viswesvaran, 2005). This situation may enhance an effective internal control mechanism as well as good corporate governance within organizations. If organizations are serious in implementing whistle-blowing as an internal control mechanism, they may need to consider enhancing ethical reasoning ability among their employees via ethics training programs. Ethics training programs have been suggested by many researchers for the development of ethical reasoning ability (Jones et al., 2003; Trevino et al., 2006).

Limitations and Directions for Future Research

There are limitations that need to be recognized in interpreting the findings. For instance, using a hypothetical vignette to evaluate whistle-blowing intention may be subject to social desirability bias. However, several preventive steps such as guaranteed anonymity and confidentiality of individual responses were taken to ensure that social desirability bias was minimized (Podsakoff, MacKenzie, Lee, & Podsakoff, 2003). Also, there is a possibility that different results might be obtained with a different sample and size. Future research should incorporate other individual and contextual variables that influence whistle-blowing intention. A mixed-method approach could be applied to strengthen the results and gain a better understanding of the hypothesized relationships. A cross-cultural study would also provide comparative results on whistle-blowing intention among employees in Western and non-Western countries.

Conclusion

To conclude, this study provides encouraging results on the role of ethical reasoning in the relationship between work experience and whistle-blowing intention. Indirectly, the findings of this study demonstrate the influence of an individual's ethical reasoning ability in making an ethical decision, in this case the intention to whistle-blow when faced with an ethical dilemma. In short, individuals' ethical reasoning ability appears to have a significant impact on their whistle-blowing intention. Future research can further expand this study by investigating the impact of other variables such as organizational ethical climate in such a relationship.

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Nadzri Ab Ghani is a senior lecturer at the Faculty of Accountancy, Universiti Teknologi MARA (UiTM), Kedah, Malaysia. He has been with UiTM for more than fifteen years, and before joining UiTM, he was a lecturer at Institut Teknologi Tun Abdul Razak, Malaysia. He holds a Ph.D. in corporate governance (specifically in the area of whistle-blowing) from Curtin University, Australia. He is an active researcher, and his research interests include whistle-blowing, supply chain management, and accounting education.

Intan Marzita Saidon is a senior lecturer at the Faculty of Accountancy, Universiti Teknologi MARA (UiTM), Kedah, Malaysia. She has more than twenty years of experience teaching various accounting courses in UiTM. She obtained her first degree from Northumbria University, UK, and holds a Ph.D. from Curtin University, Australia. She is an associate member of the Malaysian Institute of Accountants. Her present research interests include ethics, strategic management, and accounting education.

Part II
Governance Issues in Organizations

The Enhancement of Corporate Governance in Government-Linked Companies

Khairul Anuar Kamarudin and Wan Adibah Wan Ismail

Introduction

Government's involvement in the affairs of Malaysian listed companies started with the introduction of the New Economic Policy in 1969, which aimed to eradicate poverty and reduce social inequality. Among the impacts of the policy was a significant shift of ownership and control from foreign companies to local entities. The government use a massive affirmative strategy to gain control of Malaysian assets from British interests. For example, on September 7, 1981, Permodalan Nasional Berhad (PNB) made a successful take-over of 50.41% of shares of Guthrie Corporation, which was listed on the London Stock Exchange. This strategy enabled PNB to control Guthrie Corporation, a large plantation company in Malaysia controlling more than 76,000 hectares of rubber, oil palm and cocoa.

In 1983, the Malaysian government announced a privatization policy with the objectives of relieving the financial and administrative burden of the government and reducing the size of the public sector. The policy also aimed to increase competition, efficiency, productivity, and economic growth through private entrepreneurship.[1] The privatization strategy resulted in the incorporation and listing of numerous state-controlled listed firms such as Tenaga Nasional Berhad (the national power generator and distributor), Malaysian Airline System Berhad (the national airline), and Telekom Malaysia Berhad (the national telecommunications provider). Several methods of privatization were employed, but the most significant were 'Share Issue Privatizations'.

[1]Please refer to Economic Planning Unit Prime Minister's Department of Malaysia, Guidelines on Privatization (1985) and (1991).

K. A. Kamarudin · W. A. Wan Ismail (✉)
Universiti Teknologi MARA (UiTM) Kedah, Merbok, Malaysia
e-mail: wadibah@uitm.edu.my

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Even though the shares of these listed firms are made available to the public for investment, the Malaysian government, through the Ministry of Finance and other Government-Linked Investment Companies (GLICs), owns substantial amounts of the shares, especially in firms of public importance. For instance, in the utility, plantation, and financial sectors, privatized firms remain in government control. However, the government also disposed of significant amount of holdings in certain business entities to private investors. For example, Sports Toto Malaysia Sdn Bhd, which ran Toto betting, was privatized in 1985 when its Chief Executive Officer, Vincent Tan Chee Yioun, acquired 70% of the paid-up capital through his private company.

In certain cases, the government holds golden shares, which enable the holder (government) to outvote or veto all other shares (World Bank, 1999). For example, certain matters require the express consent of the holder of the share or it may confer special rights in the appointment of the board of directors (World Bank, 1999). As such, the government has a power to appoint board members and senior management, and to make major decisions such as contract awards and restructuring and divestments, though in most cases it is not the ultimate beneficial owner.

The government control of public firms in Malaysia is achieved through various agencies and investment entities. Khazanah Nasional (Khazanah) is an investment holding arm of the Government of Malaysia and has investments in over 50 major firms covering a broad spectrum of industries. Khazanah is responsible for driving shareholder value creation and enhancing corporate governance in firms controlled by the government. Apart from Khazanah, Petroliam Nasional (Petronas), a national and wholly-owned oil company, has also invested a substantial amount of capital in the equity market.

The Malaysian capital market also has significant investments from other government agencies and fund managers, such as the Employees Provident Fund, Kumpulan Wang Persaraan, Lembaga Tabung Angkatan Tentera, Lembaga Tabung Haji, and Permodalan Nasional Berhad. The Employees Provident Fund (EPF), for example, was established under the Employees Provident Fund Act 1991 (Act 452) to provide retirement benefits for its members. Currently, employees contribute 11% of their pay, while employers contribute 12% to the fund. Kumpulan Wang Persaraan is a fund providing retirement benefits specifically for the public sector. In addition, Lembaga Tabung Angkatan Tentera (LTAT) is a superannuation scheme for serving members of the Armed Forces. For officers, participation is voluntary, but other ranks are required to contribute 10% of their monthly salary to LTAT, while the government, as employer, contributes 15%. The LTAT fund has invested in several areas, including retail business and cash investments such as bonds, fixed deposits and equities. In addition, Boustead Holdings Berhad, a subsidiary of LTAT, is invested in various businesses including plantations, heavy industries, properties, finance, pharmaceuticals, manufacturing, and trading.

On March 17, 1978, the Malaysian government established the Permodalan Nasional Berhad (PNB) to encourage share ownership among Bumiputera. Initially, PNB catered for only one ethnic group. The PNB mutual fund, Amanah Saham Nasional, for instance, was entirely for members of the Bumiputera ethnic group. Subsequently, the PNB introduced other mutual funds such as Amanah Saham

Wawasan 2020, Amanah Saham Malaysia, Amanah Saham 1Malaysia, and Amanah Saham Gemilang, in which all Malaysians are eligible to invest. Currently, the PNB investments involve more than 360 firms in Malaysia. In addition, the PNB has gained control of Malayan Banking Berhad, NCB Holdings Berhad, MNI Holdings Berhad, and Sime Darby Berhad.

The Lembaga Tabung Haji (or Future Pilgrims Fund Corporation) was set up in 1963 to help the Malaysian Muslim community in performing Hajj (pilgrimage). Previously, pilgrims from rural areas sold their livestock or properties to cover their hajj (pilgrimage) expenses. The establishment of Lembaga Tabung Haji helps them to plan their savings for the pilgrimage and provides pilgrimage management services. In 1969, the Pilgrimage Fund Management Board was established under the Pilgrimage Fund and Management Board Act 1969 (Act no 8), which marked significant investment of Lembaga Tabung Haji in the Malaysian capital market. Currently, Lembaga Tabung Haji controls two public listed firms: TH Plantations Berhad and Bank Islam Malaysia Berhad, which is involved in the business of oil palm plantations and Islamic banking, respectively.

ValueCap and Social Security Organization (SOCSO) also invested funds in Bursa Malaysia. Khazanah Nasional Bhd, Permodalan Nasional Bhd, and Kumpulan Wang Persaraan equally own ValueCap, which invests heavily in high-growth stocks. On the other hand, SOCSO was established in 1971 under the Employees' Social Security Act 1969 (Act 4) and is responsible for social security schemes, namely the Invalidity Pension Scheme and the Employment Injury Insurance Scheme. Through these schemes, SOCSO protects workers against industrial accident, including accidents that occur while working, occupational diseases, becoming an invalid, or death due to any cause. Workers contribute monthly to SOCSO, which then invests in various instruments including the equity market.

Other than the federal government, Malaysia has thirteen state governments. Every state government has established a State Economic Development Corporation (SEDC), which acts as the investment holding arm of the State. For example, Johor Corporation, an investment arm for the Johor state government, has significant investments in the Malaysian economy, with more than 280 member companies. These include several listed firms such as KPJ Healthcare Bhd, Kulim Bhd, Damansara Realty Bhd, QSR Brand Bhd, Sindora Bhd, and KFC Holdings Bhd.

All of the above examples show that Malaysian government has significant involvement in the country's economy. Even though the number of GLCs only represents less than 10% of the firms listed on Bursa Malaysia, these firms account for approximately MYR 260 billion in market capitalization, or approximately 36% of the Bursa Malaysia market capitalization (Wan Ismail, Kamarudin & Othman, 2012).

In January 2005, the government established the Putrajaya Committee on GLC High Performance (PCG) to develop comprehensive national policies and guidelines to transform GLCs into high-performing entities. A report issued by PCG shows that the performance of GLCs is below the market average.[2] A substantial number of

[2]PCG, Catalyzing GLC Transformation to Advance Malaysia's Development. Kuala Lumpur: Putrajaya Committee-GLC High Performance (2005).

GLCs were also removed from the official list of Bursa Malaysia because of poor performance. PCG is responsible for implementing and overseeing the implementation of these policies and guidelines to transform GLCs into high-performing firms. To improve the performance of GLCs, several restructuring strategies have been undertaken, including the merger of Kumpulan Guthrie Bhd, Sime Darby Bhd, Golden Hope Plantations Bhd, and the bulk of their subsidiaries.

In terms of corporate governance, PCG has undertaken various initiatives to strengthen the governance of state-controlled firms. On July 29, 2005, PCG introduced the 'Green Book', a framework to guide GLC transformation and upgrade the effectiveness of GLCs' boards of directors. The transformation program covers comprehensive aspects of firm management, including guidelines and programs to enhance the effectiveness of the board of directors and reinforce strong corporate governance in state-controlled firms. Section 2 of the Green Book specifies corporate governance aspects such as board composition, separation of the roles of the Chairman and CEO, a cap on the number of directorships, directors' compensation, an annual review of Director and Board performance and many others. In addition, on March 23, 2006, to promote financial transparency, fifteen GLCs made public their key performance indicators (KPI) and financial and operational targets in local newspapers.

Given the emphasis on improving the performance and governance of the government-linked companies, it is expected that the establishment of PCG will result in stronger corporate governance that could result in better financial reporting quality of the GLCs. Thus, it is the objective of this study to examine whether the corporate governance of government-linked companies in Malaysia has improved over the period 1999–2011, especially after the establishment of the Putrajaya Committee on GLC High Performance.

Literature Review

The importance of corporate governance in ensuring effective monitoring has been widely discussed in prior literatures. However, the literature provides no common definition of what corporate governance is. Some studies define corporate governance as being the means to protect the stakeholders' rights. Shleifer and Vishny (1997) explain that corporate governance is a set of instruments that should be in place to guarantee the maximum rate of return on investments of the shareholders and creditors of a company. Similarly, John and Senbet (1998) state that corporate governance is the mechanisms to protect shareholders' interests, by which shareholders of a corporation exercise control over corporate insiders and management. According to Labelle, Gargouri, and Francoeur (2010), corporate governance is the set of principles or rules aimed at improving the accuracy and reliability of financial statements to insure investors' protection. Based on the agency perspective, a narrower definition is provided in Mitton (2002), who defined corporate governance as the means by which minority shareholders are protected from expropriation by

managers or controlling shareholders. Corporate governance acts as controls that govern the behavior of managers and define their discretionary powers, and serve as to offset potential losses due to the conflict of interest between shareholders and managers (Bozec & Bozec, 2007).

Another group of studies defined corporate governance in terms of the connection between the stakeholders. Monks (1994) states that corporate governance is the relationship between the various participants who determine the direction and performance of corporations. According to Tricker (1994), corporate governance helps address the issue facing the boards of directors, including the interaction with top management, and relationship with the owners and others interested the affairs of the company, such as the creditors, debt financiers, analysts, auditors and corporate regulators.

Corporate governance is also defined as a monitoring process or system. For instance, Demb and Neubauer (1992) defined corporate governance as the process by which corporations are made responsive to the rights of stakeholders. Cheung and Chan (2004) defined corporate governance as the system through which the behavior of a company is monitored and controlled. They explain that corporate governance is significant especially in modern economies large corporations, which are typically characterized by separation between the parties who provide the capital and the parties who manage the resources. Corporate governance could minimize the conflict of interest among the two parties and ensure that the company is properly monitored (Cheung & Chan, 2004).

In Malaysia, the Finance Committee on Corporate Governance defined corporate governance as '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 into account the interests of other stakeholders' (Finance Committee on Corporate Governance, 2000).

Although the definition of corporate governance in the literature varies, it is basically concerned with both the internal controls and board structure, and external aspects including the relationship with shareholders and stakeholders (Rahman & Ali, 2006). Corporate governance encompasses the various mechanisms available to constrain the opportunistic behavior of management and, consequently, results in more credible and relevant accounting information for users.

Despite the significant involvement of Malaysian government in the Malaysian capital market, studies that examined corporate governance issues of government-linked companies are still at sparse. Related studies by Tomasic and Fu (2006) examine some issues that arise in government-owned companies in two countries, Australia and China. They found that the significant domination of government in the ownership of the companies could potentially undermine the fundamental features of modern corporations. Tomasic and Fu (2006) claim that corporate governance standards and guidelines are very important in these companies to bring about greater integration between their commercial and non-commercial roles.

Research Design

Data

Our sample covers all GLCs from the beginning of 1999 to the end of 2011. There are two main reasons for using the firms listed during this time period. First, period prior to the year 1999 is associated with the 1997–1998 Asian Financial Crisis; hence we control this effect by restricting the lower limit to year 1999. Second, the establishment of PCG in 2006 enables merely comparable sample between post- and pre-PCG. The data were collected from the Worldscope database and corporate annual reports. The GLCs were identified from the disclosure made by the Putrajaya Committee on GLC High Performance which includes all government-linked companies (GLCs), or their subsidiaries or affiliates, or government-linked investment companies (GLICs). In addition, we also included companies that are under control, direct or indirect, of any of the thirteen state governments. For instance, Kumpulan Perangsang Selangor Berhad is a firm over which the State Government of Selangor has direct control; hence we classified this firm as a GLC.

Regression Model

In this research, we use a binary classification to divide the sample into two categories: the period before PCG (pre-PCG) and period following the PCG (post-PCG). Since the dependent variable (PCG) is binary in nature, we applied logit regression with the following model to test changes in corporate governance between the two periods:

$$\begin{aligned} \text{PCG} = {} & \beta_0 + \beta_1\text{CHRMN_IND} + \beta_2\text{BOD_SIZE} \\ & + \beta_3\text{BOD_NONEXEC} + \beta_4\text{BOD_MEET} \\ & + \beta_5\text{BOD_ATTEND} + \beta_6\text{AC_SIZE} \\ & + \beta_7\text{AC_IND} + \beta_8\text{AC_EXPERT} + \beta_9\text{AC_MEET} \\ & + \beta_{10}\text{AC_ATTEND} + \beta_{11}\text{BIG4} \\ & + \beta_{12}\text{NONAUDIT_FEE} + \beta_{13}\text{DIR_REMUN} \\ & + \beta_{14}\text{AUDIT_FEE} + \beta_{15}\text{ROA} + \beta_{16}\text{SIZE} \\ & + \beta_{17}\text{GROWTH} + \beta_{18}\text{RISK} + \varepsilon \end{aligned} \tag{1}$$

where PCG is a dummy variable that equals 1 if the sample is from period following the PCG transformation plan, otherwise 0; CHRMN_IND is a dummy variable that takes value 1 if the chairman is an independent directors, otherwise 0; BOD_SIZE is the size of board of directors; BOD_NONEXEC is the proportion of non-executive directors to total number of directors; BOD_MEET is the number of BOD meeting during the year; BOD_ATTEND is the percentage of attendance for BOD meeting;

AC_SIZE is the size of audit committee; AC_IND is the proportion of independent members of audit committee to total size of audit committee; AC_EXPERT is the proportion of members of audit committee with financial expertise to total size of audit committee; AC_MEET is total number of audit committee meeting during the year; AC_ATTEND is the percentage of attendance for audit committee meeting; BIG4 is a dummy variable that takes value 1 for firm audited by Big4 auditors, otherwise 0; NONAUDIT_FEE is proportion on non-audit fees to total fees; DIR_REMUN is the natural logarithm of directors' remuneration; AUDIT_FEE is the natural logarithm of audit fee; ROA is return on assets; SIZE is the natural logarithm of total assets; GROWTH is price to book ratio; RISK is the proportion of total assets to total debts.

Findings

Analysis of Change in Corporate Governance

Figures 1, 2, 3, and 4 illustrate the change in corporate governance from the period 1999–2011. Figure 1 shows the proportion of firms with independent chairman and Big4 auditor. The line chart shows that the proportion of companies with independent chairman has increased over time.

While for Big4 auditors, the proportion does not vary much except for the year 1999, where less than 70% of firms appointed Big4 auditors. Other years denote a proportion ranged between 80 and 90%.

Figure 2 shows that board size increases slightly over the period 1999–2011, whereas audit committee size maintains over the same period. In terms of board meeting, the year 2000 recorded the highest average number of meeting over the

Fig. 1 Analysis of change in chairman independence and appointment of Big4 auditor

Fig. 2 Analysis of change in board and audit committee's size and number of meetings

Fig. 3 Analysis of change in board independence, board attendance and audit committee attendance

period. The number of meetings decreased dramatically in the year 2001 and continued to fall slowly until it touched the lowest point in 2004. The number reached a peak again in the year 2006, before it starts to decrease a year later. The frequency of meeting started to improve again in the years 2010 and 2011. Interestingly, audit committee meeting was less frequent compared to the board meeting, but followed the same pattern over the period of study.

The line chart in Fig. 3 shows significant increase in audit committee member's attendance in the year 2001. This is followed by a steady rise of committee member's attendance for the rest of the period under study. For the attendance of board of directors' meeting, the figure denotes continuous increase from the year 2000–2011. No

Fig. 4 Analysis of change in audit committee independence and expertise, and non-audit fee

disclosure of attendance, for audit committee and board of directors, were provided in the annual reports for the year 1999. For BOD_NONEXEC, board independence, upward pattern were documented over the studied period.

Audit committee independence and the proportion of financial expertise in audit committee show improvement over the years, as shown in Fig. 4. The audit committee independence increased from less than 0.40 in 1999 to 0.45 in 2011. Similarly, the proportion of financial expertise in audit committee increased from less than 0.20 in 1999 to 0.35 in 2011. The proportion of non-audit fees to the total audit fees fluctuated with overall downward trend. This shows that firms slowly reducing the non-audit fees supplied by the incumbent auditors, in line with recommendation made in the Malaysian Code of Corporate Governance.

Main Empirical Findings

Table 1 provides empirical results from the regression to test the effect of GLCs transformation program on corporate governance mechanisms. The coefficient for BOD_NONEXEC (the proportion of non-executive directors to total number of directors) is positive and significant at the 5% level, suggesting that a larger proportion of non-executive directors in GLCs following the transformation plan. The finding is consistent with our prediction. The coefficients for AC_IND and AC_EXPERT are also positive and significant at 5% level, where the coefficient value of −2.931 and −1.735, respectively. These results show that the more independent directors were appointed as a member for the board of directors, particularly audit committee. In addition, the proportion of audit committee members with financial expertise, including members of MIA and other accounting professional bodies, have

Table 1 Logit regression estimates of PCG on corporate governance variables

	Basic regression		Robust regression	
Statistics	Coeff.	*z*-stat.	Coeff.	*z*-stat.
INTERCEPT	18.675*	4.736	18.675*	4.558
CHRMN_IND	0.241	0.591	0.241	0.639
BOD_SIZE	0.070	0.934	0.070	0.845
BOD_NONEXEC	**2.795****	**2.254**	2.795**	2.427
BOD_MEET	−0.023	−0.574	−0.023	−0.563
BOD_ATTEND	**6.176***	**2.767**	6.176*	2.704
AC_SIZE	−0.296	−1.605	−0.296***	−1.664
AC_IND	**2.931****	**2.462**	2.931**	2.320
AC_EXPERT	**1.735****	**2.053**	1.735**	2.059
AC_MEET	0.093	1.445	0.093	1.451
AC_ATTEND	1.577	0.901	1.577	0.875
BIG4	−0.374	−1.060	−0.374	−1.061
NONAUDIT_FEE	−0.362	−0.691	−0.362	−0.694
DIR_REMUN	**0.518****	**2.391**	0.518**	2.318
AUDIT_FEE	**0.366*****	**1.867**	0.366***	1.852
ROA	0.108	0.076	0.108	0.068
SIZE	−0.397	−1.355	−0.397	−1.347
GROWTH	0.190	1.533	0.190	1.399
RISK	**−2.169***	**−2.988**	−2.169*	−2.846
Pseudo R squared	0.125		0.125	
Observations	404		404	

Asterisks denote statistical significance at the 1% (*), 5% (**), or 10% (***) level, respectively

increased significantly following the transformation plan. These results signify a serious effort made by government to strengthen the oversight roles of audit committee. The results also show higher attendance rate of board meeting in the period following the GLCs transformation as compared to pre-transformation period. The coefficient for BOD_ATTEND is positive and significant at 5% level.

For the control variables, Table 1 shows that directors' remunerations and audit fees have increased significantly after 2006 (transformation plan), which is consistent with the increases of directors' remunerations and audit fees over time. The period following the transformation also recorded a lower risk, where a lower percentage of assets to total debt were found compared to pre-transformation period. Other control variables are not significant.

Apparently, the period following the transformation program recorded an increase of corporate governance mechanism including the proportion of non-executive directors, the proportion of financial expertise and independent directors in the audit committee and attendance rate of BOD meeting. Though other corporate governance

mechanism does not improve significantly, the mechanism prior to transformation plan already good and well-established. For instance, none of GLCs have duality problem and in average more than 80% of GLCs were audited by Big4 audit firms.

Conclusions

This study aims to provide empirical evidence of the effect of PCG transformation plan on various corporate governance mechanisms. This study finds that the post-transformation plan period is associated with higher proportion of non-executive directors to total number of directors, more independent directors were appointed as a member for the board of directors, the proportion of audit committee members with financial expertise, attendance rate of board meeting, higher fees paid to auditors and higher remunerations for directors.

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Khairul Anuar Kamarudin is a senior lecturer at Universiti Teknologi Mara, Malaysia. He has a doctoral degree from Victoria University of Wellington, New Zealand. His research areas include auditing, corporate finance, corporate governance, and financial reporting. His research is published in, among others, Asian Review of Accounting, and Journal of Islamic Accounting and Business Research. Khairul also presented a paper at a plenary session of Journal of Accounting and Economics (JCAE) 2019 Annual Symposiums, and other conferences—AFAANZ conference and Canadian Academic Accounting Association Annual Conference.

Wan Adibah Wan Ismail is a senior lecturer at the Faculty of Accountancy, Universiti Teknologi MARA. She has a doctoral degree from Victoria University of Wellington, New Zealand. Wan Adibah's research interest is in the area of financial reporting, corporate governance, and corporate ownership. Her publication in the Asian Review of Accounting, Vol. 21, 2013, titled 'Earnings quality and the adoption of IFRS-based accounting standards: Evidence from an emerging market' won the Emerald Literati highly commended paper and was among the most-cited paper in the journal. The most recent publication titled 'The quality of earnings in shariah-compliant companies' was published in the Journal of Islamic Accounting and Business Research.

Whistleblowing: A Mechanism for Better Governance

Noor Afza Amran

Introduction

Most of the time corruption occurs in secrecy; thus, only individuals engaged in corrupt affairs or those working closely with them in an organisation are in the best position to report (Dyrmishi, Hroni, & Gjokutaj, 2013). Wrongdoings such as unethical business conduct and fraudulent practice breads a disordered atmosphere in an organisation and inhibits organisation performance. Due to the detrimental effect of unethical business practices, business organisations across the globe are forced to look inward on possible channels through which perceived cases of wrongdoings within the organisation can be promptly exposed and deterred. Globally, policy makers and academic researchers have recognised whistleblowing as an important tool to expose illegal activities being perpetrated within an organisation.

Pursuant to that, whistleblowing is widely accredited as one of the most powerful method to prevent and detect corruption and malpractices (Transparency International, 2009). Nevertheless, very few decided to blow the whistle. The refusal to report wrongdoings that have been observed may be closely related with the fear of retaliation by the employers or persons being alleged for malpractices (Gundlach, Martiko, & Douglas, 2008; Kaplan & Kleiner, 2000; Paul & Townsend, 1996; Transparency International, 2010).

Therefore, a push for the implementation of a system of whistleblowing and for the protection of whistle-blowers who disclose such information is on the raise in the international arena (Transparency International, 2010). For instance, international organisations like the Council of European Anti-Corruption Convention, the Inter-American Convention Against Corruption, the African Union Convention Against Corruption, the Anti-Corruption initiative for Asia-Pacific, the OECD guidelines, the Southern African Development Community (SADC) protocol, the United

N. A. Amran (✉)
Universiti Utara Malaysia, Changlun, Malaysia
e-mail: afza@uum.edu.my

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Nation Convention Against Corruption (UNCAC) are all in the forefront agitating and encouraging members to establish measures and procedure that deters wrongdoing.

Not surprising, most organisations in both public and private sectors now adopt a self-regulatory method by incorporating a comprehensive and effective whistle-blowing policy and procedures to ease and encourage reporting of unethical conducts. Beside its significance in exposing unethical conduct, the innate fear instilled as a result of invincible eyes watching wrong doers subdue the tendencies of perpetrating such acts. In the present dispensation, public outcry about malfeasance has created a favourable environment for whistleblowing. The role of whistleblowing act in achieving effective governance and promoting culture of transparency has been widely recognised across sectors.

In the USA, successful cases of employees blowing whistle on suspected case of corporate fraud and malpractice have been on the increase. This has spurred the ongoing discussion on the effective whistle blowing as an internal control mechanism in both developed and developing countries. Stories of corporate malfeasance involving Enron, Tyco, WorldCom and many other large corporations in the early millennium evidenced the effectiveness of whistle blowing. Unethical and sharp business practices in the aforementioned corporations were brought into public domain by their employees. The Association of Certified Fraud Examiner gave the severity of related fraudulent activities in companies without whistleblowing mechanism to be very high compared to those with such mechanism. In the report issued by the Association of Certified Fraud Examiner in the USA in 2014, 42.2% of detected frauds resulted from the activities of the whistle-blowers. Advocators of implementation of whistleblowing cited improvement in organisation efficiency, worker morale and improved ethical conduct within the organisation has some of the accrued benefits derived by companies instituting whistleblowing system (Callahan, Dworkin, Fort, & Schipani, 2002).

Literature Review

Definition of Whistleblowing

Several definitions describing the ethos of whistleblowing have been put forward by scholars and constituted authorities. According to Miceli and Near (1985), whistleblowing is "the disclosure made by an organisation member (former or employee) of an illegal, immoral or illegitimate practise under the control of employer to persons or organisation that is able to effect corrections". In similar words, the UK Committee on Standards in Public Life define whistleblowing "as raising a concern about malpractice within an organisation", while the International Labour Organisation defines whistleblowing as "the reporting by employees of illegal, irregular, dangerous or unethical practice by employers". Dato Zarinah Anwar, the former Chairperson of the Securities and Exchange Commission Malaysia described whistleblowing as the disclosure of information that one can reasonably believe to be evidence of

contravention of any law or regulation or information that involves mismanagement corruption or abuse of authority. Whistleblowing is defined as disclosure actions by members of an organisation of illegal and immoral acts perpetrated by the organisation and organisation members to persons or organisations that may bring about a change (Boatright, 2003).

What can be distilled from all the definitions is that the whistle-blower either anonymously or unanimously reports actual or perceived illegitimate acts of societal consequence perpetrated by an organisation or some of its members to a third party (either internal or external) who is in a position to correct the wrong. Such fraudulent act is mostly disclosed by the organisation's employees, the reason being that, fraudulent acts are difficult to unravel by outsiders because they are carefully concealed acts that only the perpetrators have knowledge about. For this reason, only few people (employee's current or past) within the organisation are more likely to discover beforehand and raise alarm at an early stage before any havoc can be wrecked. Though the issue of whistleblowing has been on for several decades, renewed interest emerged in it with the passage of Sarbanes Oxley Act in 2002 following Enron's collapse. So far, activities of whistle-blowers are acclaimed to be an effective mechanism to fight fraudulent activities, most especially given the current economic climate where ethics is becoming a serious issue. In next sections, legislation that gave protection to whistle-blower's in Malaysia is reviewed. Then, implementation issues bedevilling the success of Whistleblowing Act and the effectiveness of whistleblowing in fostering good corporate governance practices are discussed.

Whistle-Blower Protection Act

Some developed countries such as UK, USA and Australia have begun to introduce best practise legislation Act (i.e. the Whistle-blower Protection Act) in order to encourage whistleblowing. The Act made provisions for those involved in whistleblowing to be protected, the extent of protection and the extent of disclosure to be made in public interest. Examples of such Acts include the UK Public Interest Disclosure Act 1998, the US Sarbanes Oxley Act 2002 and the Australia Corporation Act which were repealed to provide for protection of whistle-blower. Malaysia followed suit by introducing the Whistle-blower Protection Act in 2010.

The Whistle-blower Protection Act 2010 is a law of Malaysia to combat corruption and other wrongdoings by encouraging and facilitating disclosures of improper conduct in the public and private sector, to protect persons making those disclosures from detrimental action, to provide for the matter disclosed to be investigated and dealt with and to provide for the remedies connected therewith. The Act was passed by Parliament in June 2010 and was brought into force on 15 December 2010. The objective of this Act is to give protection to the whistle-blower in the form of confidentiality of their information, immunity from civil and criminal action and protection

from detrimental action being taken against them. Whistle-blower protection is one of the Malaysian government's efforts towards tackling corruption and promoting good governance.

The whistle-blower protection law covers any member of the public and private sectors who discloses wrongdoings. Among the disclosures that intended to be disclosed are abuse of authority, violation of laws and ethical standards, danger to public health or safety, gross waste, illegality and mismanagement. The disclosure should be made in "good faith" based on "honest and reasonable grounds at the material time" without necessitating hard evidence from the whistle-blower. The duty of gathering evidence will be tasked to the investigation unit of the enforcement agencies to ensure that the whistle-blower is not compromised. However, whistle-blower can provide evidence if it is legally available through the course of their work.

The Whistle-blower Protection Act 2010 provides protection to whistle-blower who voluntarily comes forward to report or reveal information on corruption activities. This Act also encourages the public from all sectors to disclose corruption-related activities. The identity of the whistle-blower and the information provided are kept confidential from any party. Whistle-blowers are also given immunity from any civil, criminal or disciplinary action due to the revealing of the act of corruption.

Disclosure of the confidential information will be liable to a fine not exceeding RM 50,000 or to imprisonment for a term not exceeding ten years or both. A whistle-blower will not be subject to any civil action or criminal liability and no administrative process can be taken against the whistle-blower for making disclosure of improper conduct. Under the Act also, no person shall take detrimental action against any whistle-blower or person related to or associated with the whistle-blower in reprisal for a disclosure of improper conduct.

It can be said that the passing into law of the Whistle-blower Protection Act indeed signals to stakeholders and the public at large the country's commitment to good governance practice and its zero tolerance for corruption. The Whistle-blower Protection Act avails the public the opportunity of knowing concealed unethical practices going on in corporations. Central to such legislation, employees are encouraged to report wrongdoings bearing in mind that they are shielded from retaliatory actions. Therefore, it is an "inexpensive risk management tool" that can be employed in emerging economies characterised by weak enforcement mechanism.

Notably, while it will be desirable to have whistleblowing system implemented in organisation, its enforcement and monitoring of the mechanism are imperative (Lee & Fargher, 2013). Appropriate communication channels and environment where whistle-blowers are confident that concern will be treated without adverse repercussion further stimulates early detection and prevention of wrongdoings (Miceli & Near, 1985). With the passage of the Whistleblowing Legislation Act in some of the countries across the globe, both private and public organisations are further encouraged to design and implement whistleblowing policies, thus promoting a culture of transparency and accountability.

The Practice of Whistleblowing Protection Act in Malaysia

The Malaysian government's commitment towards ensuring a corrupt-free environment has been on for quite some time now. Various governmental efforts have in the past seen to the promulgation of laws protecting whistle-blowers by the Parliament. Prominent among such legislative Act is the Companies Act 1965 (Act 125) and Capital Markets and Service Act 2007 which are all sector specific. The protection under Companies Act 1965 and Capital Market Service Act 2007 is restricted as both only cover disclosure of improper conduct within the purview of breach under the two Acts. Impliedly, the alleged misconduct must be perpetrated by the whistle-blower's employer or by its officers before it can be brought to the fore.

More recently, a comprehensive and detail whistle-blower protection law, whose provisions cut across all sectors of the Malaysian economy, was passed. The Whistleblowing Protection Act was issued in 2010 by the Federal Parliament and came into force starting from December 2010. The intent of the Whistle-blower Protection Act 2010 is to promote and encourage an environment devoid of unethical practices, by facilitating disclosure of wrongdoing in both public and private sector. Purportedly, anyone having knowledge of commission of a fraudulent or corrupt act can file a complaint with appropriate agencies against the suspected party without fear of intimidation. The Act clearly gives detailed information on the types of disclosures to be made, those whom the disclosure should be made to, what qualifies and disqualifies a whistle-blower from being protected under the Act, enforcement procedures and offences and penalties impose upon contravention of the Act. The new Act protects whistle-blowers from civil and criminal actions, confidentiality of information disclosed and protection against adverse action against the whistle-blower. A breakdown of key sections of the Act is presented below.

1. **Anonymous and Confidential Disclosure Under 2010 Whistleblowing Act**

Disclosure of improper conduct could be made orally or in written. When all necessary laid down procedures as stated under Section 6 of the Act are followed, whistle-blowers are entitled to be protected under Section 7 sub Section 1 of the Act which include protection of confidential information. Confidentiality under the Act refers to information about the identity, occupation, residential and work address of the whistle-blower and the person complained of by the whistle-blower, information disclosed by the whistle-blower and any other information that if disclosed may be detrimental to others.

2. **Nature and Extent of Protection Under 2010 Whistleblowing Act**

Fears of reprisal attacks demotivate whistle-blowers from reporting wrongdoings. Such attacks could take any form ranging from disciplinary actions to subtle actions such as dismissal, suspension, demotion, denied promotions, harsh treatment from co-workers and excessive workload. In extreme cases, such individual,

i.e., the whistle-blower could be stigmatised or come under direct victimisation from employee and or co-workers. Accordingly, the whistle-blower should be protected from all this. The 2010 Whistleblowing Act makes extensive provisions to protect whistle-blowers against retaliatory actions. For instance, Section 7 of the Malaysia Whistle-blowers Act requires that disclosure about improper conduct and the identity of the whistle-blower be kept confidential. Similarly, the whistle-blower and his relatives are protected from any criminal or civil action that might arise from making such disclosure. Where a whistle-blower suffers a reprisal attack, the whistle-blower can lodge a complaint to enforcement agency that would then investigate and claim remedies for the whistle-blower. In lieu of this, the whistle-blower can personally seek redress against such detrimental action at the court of law.

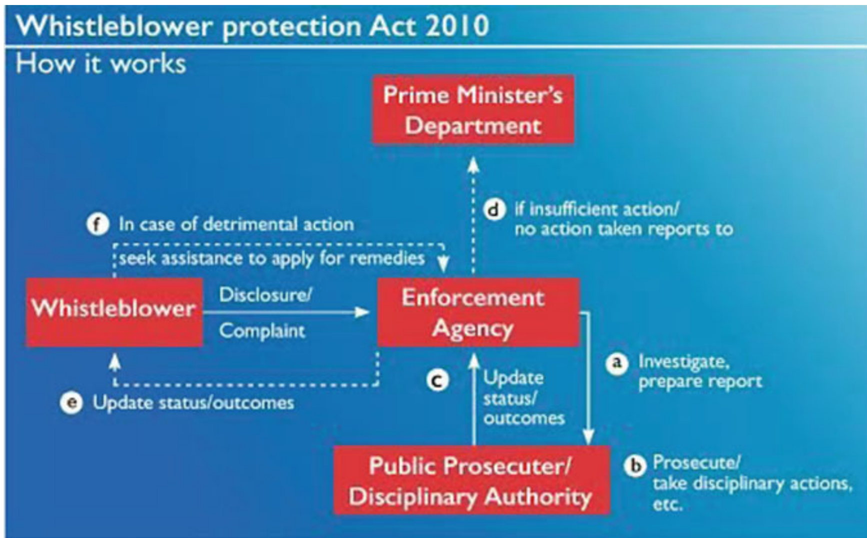
However, in order to be covered by the 2010 Whistleblowing Act, the disclosure is supposed to be made to designated agencies that fall under the purview of the Whistleblowing Legislative Act and also such disclosure must fall outside information prohibited under the Malaysia Official Secrets Act 1972. For instance, disclosures made to the media disqualify the whistle-blower from being protected by the Whistleblowing Act. So far, agencies which include Royal Malaysian Police Force, the Malaysian Securities Commission and the Companies Commission of Malaysia are recognised under the Act to carry out investigation on improper conduct and retaliatory action against the whistle-blower. More broadly defined, agencies include ministry, department, agency or body set-up by the Federal Government of Malaysia, State Government or Government-linked Companies. Importantly, it should be noted that the Act does not compel those in the knowledge of a wrongdoing to disclose; rather it encourages such disclosure by protecting whistle-blower against retaliatory actions and compel the enforcement agencies to investigate complaint on any improper action lodged.

3. Good Faith Disclosure Under 2010 Whistleblowing Act

The 2010 Whistle Act requires the whistle-blower to disclose improper conduct in good faith, suggesting that disclosure is based on "an honest belief on reasonable ground" (Transparency International, 2010). Section 2 of the Act defines improper conduct to refer to any conduct which amounts to disciplinary offences or criminal offences.

4. Disclosure Procedures Under 2010 Whistleblowing Act

Under the 2010 Whistleblowing Act, disclosures can only be made to designated government agencies. The 2010 Whistleblowing Act does not protect media reporting, although critics laid a voice of dissent on this aspect of the Act. Figure 1 gives graphical illustration about how the Whistle-blower Act 2010 works.



a Enforcement agency will investigate and prepare a report.

b The report will be forwarded to the public prosecuter or appropriate disciplinary authority for further action

c The result of the action taken will be revealed to the enforcement agency.

d If the action taken is deemed insufficient, the enforcement agency may report to the Minister in the Prime Minister's Department.

e The enforcment agency will continue to update the whistleblower on actions taken.

f Any whistleblower suffering detrimental action can complain to an enforcement agency.

Fig. 1 Whistle-blower Protection Act 2010: How it works. *Source* Prime Minister's Department

Responds Towards Whistleblowing in Malaysia

Despite applauds received at promulgation of 2010 Whistle-blower Protection Act; questions are bound as to whether the legislation will produce the expected result. Empirical evidence shows that its implementation is still at the rudimental stage. Whistleblowing remains an unpopular process through which corporate misconducts are reported. Whistle-blowers in Malaysia express the fear of reprisal attack, their concerns about not to be treated accordingly or that they are not adequately protected

under the 2010 Whistleblowing Act. Survey shows that attitude to whistleblowing in Malaysia is positive. The PwC's (2014) survey found 70% of the respondents saying that their companies have whistleblowing policies. However, 24% of those who have this mechanism have not used it in the last 24 months, and 40% claimed that the whistleblowing mechanism at their organisation was either effective or very effective and 26% says it is slightly effective. Meanwhile, detection of fraud through whistleblowing help lines is still very low with 8% rate of usage. The survey findings suggest that legislation is a necessary requirement but not sufficient enough to encourage Whistleblowing Act. Effective enforcement practices are as well important to promote compliance culture. Most importantly, a legislative environment that breeds freedom of expression, inhibit culture of secrecy and independent journalism are crucial to the successful implementation of Whistleblowing Act in any jurisdiction.

In Malaysia, existing legislation on whistleblowing seems encompassing, however, it is weakly enforced. This might be connected with the culture of secrecy within Malaysia society. In addition to this, the various bureaucracy introduced in the 2010 Whistleblowing Protection Act in some quarters is argued to discourage whistle-blowers. For instance, the Act only covers whistle-blown to only specified agencies designated under the Act. This is contrary to procedures obtainable in other countries where whistle-blowers are free to bring the issue to public domain so far as the disclosure is in good faith. In Malaysia, such action attracts a fine and imprisonment and a few cases have been reported where the whistle-blower protection was revoked due to leakage of information disclosed to a third party.

It can be argued that the Whistle-blower Protection Act in Malaysia might not produce the expected result in as much as the opaqueness in the Act is not addressed. As contained in the 2010 recommendation on Whistleblowing Act issued by Transparency International, the legal framework on whistleblowing should be clear, comprehensive and easy to use by whistle-blowers. The clause in the Act which prevents public disclosure through media deters effective whistleblowing. At least, in an appropriate circumstance, individuals should be safe to report to the media. In relation to the Act issued by Transparency International, Datuk Paul Low (2012), the president of Transparency International has confirmed that Malaysia has improved its standing in the ranking in 2013 (from 54th to 53rd). The country's position is still in the mid-range and this situation calls out for stronger measures and enforcement to be in place to eliminate entrenched interests and processes that support abuses. In the previous year of 2014, Malaysia has further improved its country ranking by climbing up to 50th position. Following this, Transparency International urged the government to take up the recommendations to ensure greater improvements, including putting more emphasis on the misuse of public funds as highlighted in Auditor-General Reports (Astro Awani, 2014).

Whistleblowing Act and Corporate Governance in Malaysia

In Malaysia, regulatory authorities in charge of corporate governance have echoed the importance of whistleblowing as a tool to promote good governance. In the 2012 Code of Corporate Governance issued by the Security Commission in Malaysia, public listed companies are mandated to design an appropriate communication and feedback channel that facilitate employee communication of their ethical concern within the organisation. Earlier on, it was mentioned that there are whistleblowing provisions contained in the 2007 Capital Market and Service Act along with the Company Act of 1965 which put burden on certain officers in the company to report breach of compliance with security laws and other laws that negatively affects the materiality of the financial statement issued by an organisation. These officers, that is, the Chief Executive, Accountants and External Auditors of listed companies are protected under the Act. All these efforts are practical evidences suggesting the important role of whistleblowing in enhancing compliance level and safeguarding the interest of investors at the capital market through containment of unethical and illegal practices in the company. Whether the implementation of whistle blowing policies encourages whistleblowing acts in Malaysia listed companies is a question that seeks for an answer. This is necessary because of the different perceptions held about whistle-blowers.

Conclusion

There has been a substantial increase in the recognition of the importance of whistleblowing as a means of reducing corruption and defusing dangerous situations. The enforcement of existing whistle-blower rules, especially of credible protection schemes for public sector whistle-blowers and the communication channel for whistleblowing should be strengthened. In sum, the significance of whistleblowing has been widely acknowledged by organisations all around the world.

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Noor Afza Amran is an Associate Professor of Tunku Puteri Intan Safinaz School of Accountancy (TISSA), College of Business, Universiti Utara Malaysia (UUM COB). Her area of interest is Corporate Governance, Auditing, and Financial Reporting Quality. Previously, she is the Coordinator for Post Graduate TISSA-UUM. She also has holds the position of Manager of Project Management and Rating Units (iPMO/SETARA) for Universiti Utara Malaysia. She has been in service for more than 20 years.

She has been granted the research funds from the Ministry of Education under Fundamental Research Grant Scheme (FRGS), University Grants, Matching Grant with ITB-Indonesia, and IMBRe-UUM Grants for topics related to corporate governance mechanisms, family performance, women involvement in the economy, green accounting and financial reporting quality. She also has secured few case study grants in the area of accounting, risk and auditing, and business management.

Dr. Noor Afza has published more than 50 articles in ISI/Scopus and refereed journals, 70 conference proceedings and 9 chapters in book. Her current H-index is 13 where her research works have received 580 citations. She has reviewed hundreds of articles for numerous journals and conferences.

The Influence of Corporate Governance Mechanisms on Financial Structure Decision

Zuria Juhari and Corina Joseph

Introduction

Accompanied by the rapid improvement in technology and high demand of production in industry, the availability of minimum resources to run the business operations could restrict the company's growth. Hence, the company is unable to finance the assets using their own fund. Modigliani and Miller (1958) examined the importance of capital structure or financial structure for a firm's market value. Financial structure is an essential tool in measuring the ability of the business to meet its long-term debt obligations, for example, the principal payment on debt, as well as, its interest payment, and other fixed debts, i.e. lease payments. Commonly, financial structure is a way on how a company finances its assets through a combination of equity, debt, or securities. Leverage is measured by debts ratios or long-term solvency ratios. Debt ratios are important to management in making a strategic decision on financial structure. The higher the ratio, the greater the risk associated with the firm's operation. Since Bursa Malaysia has required all Malaysian public listed companies to disclose Corporate Governance Statement in their annual reports (Bursa Malaysia Listing Requirement, 2002), it has overcome the companies' heavy dependency on debt financing (Suto, 2003) which affect most Malaysian public listed before the economic crisis in 1997. This study extends Abdul Rahman and Tamsir's (2011) study on 100 samples of various sectors of Malaysian public listed companies using data collected from annual reports from the year 2000 to 2002.

Z. Juhari (✉)
MSU College Sabah, Kota Kinabalu, Malaysia
e-mail: zuria@msucollege.edu.my

C. Joseph
Universiti Teknologi MARA (UiTM) Sarawak, Kota Samarahan, Malaysia

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This study differs from Abdul Rahman and Tamsir's (2011) study by several aspects. Firstly, the corporate governance mechanisms applied in this study are different. The independent variable of this study focusses on board size, directors' remuneration, CEO duality, tenure of CEO, and ownership structure, whereas the dependent variable of this study is a financial structure decision represented by leverage. To make this study differ from Abdul Rahman and Tamsir's (2011) study, the debt-to-equity ratio (DEB) as the proxy for leverage is used (Shyu, 2013; Shukur & Dev, 2012). Abdul Rahman and Tamsir (2011) measured the financial structure using debt ratio. DEB is chosen to measure the financial structure of this study because it is a financial ratio that calculated the proportion of shareholder's equity and debt is used to finance a company's assets. DEB is closely related to leveraging, and also known as risk, gearing, or leverage. However, debt ratio measures the percentage of the company's assets financed by debt instrument.

Referring to the financial crisis in 1997, the main factor contributing to the failure of the financial decision was the poor corporate governance practice. Cebenoyan and Strahan (2004) also stated that the major contributory factor behind such ill-advised investment decision was as a consequence of ineffective corporate governance practices. Poor corporate governance leads to a weak financial structure, over-leveraging by companies, lack of transparency in financial disclosure, ambiguous responsibilities, and others. Understanding the corporate governance mechanisms helps to reduce agency costs; hence, examining the separation of ownership and management is important to protect shareholders' rights. Ownership structure is closely related to agency cost where the manager as an agent and the owners as principal have a conflict in serving their own self-interest.

The Malaysian Code on Corporate Governance 2007 was initially issued as a guideline for enhancing corporate governance practices. The MCCG 2007 code was revised and amended to the Malaysian Code on Governance 2012 (MCCG 2012) by the Securities Commission Malaysia in 2011, where it focusses on the role of the board in applying good corporate governance in dealings with their business. MCCG 2012 focusses on board of director's responsibilities in providing leadership, improving board efficiency through strengthening its composition, and reinforcing its independence. The objective of this paper is to investigate on the relationship between corporate governance mechanisms (board size, director's remuneration, CEO duality, tenure of CEO, and ownership structure) and financial structure decision of Malaysian's firms. The corporate governance is expected to mitigate the agency cost that is caused by the financial structure, due to the separation of control over the ownership and management teams.

The capital structure (financial structure) theory had been developed by Modigliani and Miller (1958). There are a number of studies extended to the financial structure theory such as Md-yusuf, Yunus, Zahraatul, and Supaat (2013) on determinants of capital structure. However, very limited studies examined the type of financial structure decision chosen by the companies and the influences of corporate governance on financial structure decisions in developing country such as Malaysia. In this study, the financial structure decision refers to leverage, indicating the debt financing.

Financial structure has been widely discussed since Modigliani and Miller (1958) theory. The theory has encouraged other main theories, for example, the pecking order theory, trade-off theory, and agency theory to investigate the financial structure decision chosen by the companies in both developed and developing countries. Debt financing and equity financing are main resources of capital in business. An optimal capital structure is when there is a balance between debt and equity. Debt can be categorized as short-term and long-term debt. Short-term debt includes account payable and short-term bank loan. Long-term debt consists of bonds, long-term notes payable and long-term loan. Equity normally contains common stock, preferred stock, and retained earnings. The formed financial structure is mostly referred to as leverage. The financial structure is important because it is related to the capability of the company to meet its shareholders' needs. The conflict of interests between agent and principal could influence firms' financing structure decision (Jensen & Meckling, 1976). Modigliani and Miller (1958) argued that capital structure is not relevant in determining the firm's value and forecasting future firm's performance.

In Malaysia, corporate governance has continued to receive attention since the financial crisis in 1997. Therefore, the Malaysian Institute of Corporate Governance and the High Level Finance Committee were formed in 1998 to educate and build awareness among corporate stakeholders on corporate governance best practices. This has resulted in the introduction of the Malaysian Code on Corporate Governance 2000, which was revised to the Malaysian Code on Corporate Governance 2012. The companies are compulsory to disclose the corporate governance practices in annual reports. Bodaghi and Ahmadpour (2010) stated that corporate governance involves processes and structures that assist in the creation of shareholders' value via management of corporate business in a proper way to ensure the protection of stakeholders. The board of directors is responsible to manage the firm and its operation.

Agency theory explains how to best organize relationship in which one party determines the work while another party does the work. An agency problem occurs when managers own a small portion of company's shares. This small fraction ownership may lead managers to work less heartily or taking more privileges (company cars, luxurious offices, expensive hotels) because the costs are borne by the owners (Jensen & Meckling, 1976). The managers will be motivated to serve the shareholder's interests through contract that can benefit the managers by the company's share. Furthermore, managers can determine their decisions to maintain their own professional reputation.

When agency conflicts arise, agency costs would be incurred. An agency cost as defined by Jensen and Meckling (1976) was a sum of: (1) the monitoring expenses by the principal, (2) the bonding expenses by the agent, and (3) the residual loss. The managers are motivated to pursue their own interest if the managers hold a small portion of the company's shares (Mat Nor & Sulong, 2007). The agency theory suggested potential conflict of interest among stakeholders when the companies make financial decisions, conflicts between managers and shareholders, and conflicts between shareholders and debt holders (Jensen & Meckling, 1976). The conflict could be a potential type of financial structure. This agency costs are recognized as cash flow

hypothesis (Jensen, 1986). The managers who possess large free cash flow tend to maximize resources under their control and invest in the low return projects without distributing the return to shareholders. Companies could change financial structure to settle this agency problem. Company with expected future growth opportunities could help to limit the free cash flow from overinvestment. Debt also could be used to identify management's readiness in paying the cash flow. Increase in debt forces managers to pay future surplus free cash flows for interest and compensation. Therefore, companies can reduce agency costs on free cash flow by using debt. Moreover, high level of debt leads to the high bankruptcy risk if companies could not settle the debt on time. These potential bankruptcy costs encourage managers to work harder to make valuable investment decisions and reducing the bankruptcy risk (Grossman & Hart, 1980).

Research Framework

The framework of this study can be described as below (Fig. 1). Independent variables are represented by board size, director's remuneration, CEO duality, tenure of CEO, and ownership structure, whereas the dependent variable is leverage, used as a proxy of financial structure decision. Control variable of this study is represented by firm's size.

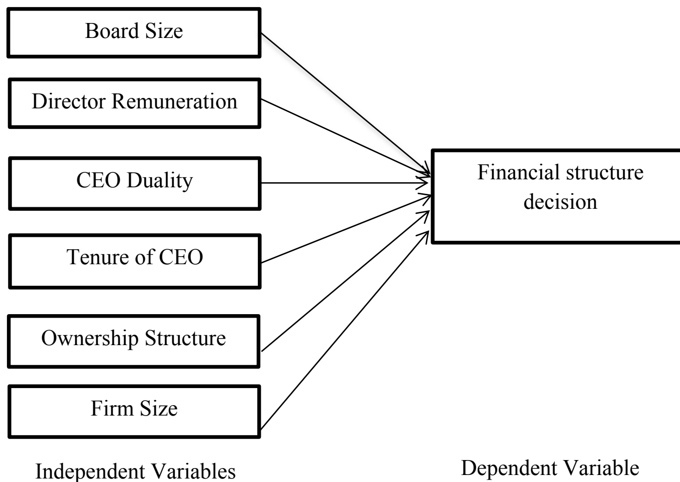

Fig. 1 Theoretical framework

Hypotheses Development

This study conducted five hypotheses to test the relationship between corporate governance mechanisms and financial structure decision.

Board Size

The responsibility of the board of directors is to make strategic decisions (i.e. financial structure). Vakilifard, Gerayli, Yanesari, and Ma'atoofi (2011) examined Tehran Stock Exchange (TSE) companies in Iran over the period 2005–2010 and found a negative relationship between board size and leverage. A study by Brenni (2014) also found the same result when examining 26 real estates of London Stock Exchange (LSE) in UK The result was in line with Berger, Ofek, and Yermack (1997) who found a larger board size that motivates a strong security in the board to pursue lower leverage to increase firm performance. The result shows that larger board of directors tend to use more debt to fund the firms' operation as compared to the equity.

In contrast, Jensen (1986) found a positive significant relationship between board size and debt-to-equity ratio. Similar to Wen, Rwegasira, and Bilderbeek's (2002) study on firm's financial structure in Chinese listed firm, a significant association between board size and financial structure is established. Anderson, Mansi, and Reeb (2004) argue that generally the cost of debt is lower for companies with bigger number of directors on board. The results indicate company with higher board size tend to use debt (external resources) than equity to finance the company's activities. This would reduce agency costs of the companies. Therefore, this study formulated the first hypothesis as below:

H1: There is a positive significant relationship between board size and companies' financial structure decision.

Directors' Remuneration

Directors' remuneration can be measured by total salaries, fees, bonuses, and other benefits that are allowed by the company. MCCG 2012 in recommendation 2.3 suggests the board should issue a formal and transparent remuneration plans and ways to attract and retain the directors. Brenni (2014) has revealed a negative relationship between director's remuneration and leverage. In his study on 26 real estate companies in (LSE) in UK over the years of 2000–2009, the results indicate that CEO's remuneration is negatively related to leverage. In line with Wen et al. (2002), there is a negative and insignificant relationship between directors' remuneration and capital structure. CEO with a good remuneration prefer to use lower leverage to avoid the

financial risk and as a way to secure their jobs and valuable compensation. On the other hand, Ortiz-Molina (2007) has analysed 1652 CEOs in firms from 1993 to 1999 and found that CEO-pay performance resulted decreased in straight-debt, but increased in firms' convertible debt. The results show there is a positive relationship between leverage and executive compensation practices. The agency theory suggests that the agent is performing on behalf of the principals which involve delegating some decision-making authority to the agent. However, the agent is not always acting in the best interest of the principal. In order to limit the disappearance of the principal's interest, the appropriate incentives for the agent could reduce the aberrant activities (Jensen & Meckling, 1976). Thus, the second hypothesis is developed as follows:

H2: There is a positive significant relationship between directors' remuneration and companies' financial structure decision.

CEO Duality

CEO duality refers to a CEO who serves as the chairman of the board at the same time. Vakilifard et al. (2011) examined data from Tehran Stock Exchange and found a positive relationship between CEO duality and leverage. Emamgholipour, Ramezani, Behzadnia, and Rekabdarkolaei (2013) examined the relationship between CEO duality and capital structure of 665 companies of the Tehran Stock Exchange in years 2006–2010. The result shows a significant positive relationship between the CEO duality and capital structure. A positive relationship between CEO duality and capital structure is also found in Nazir's (2012) study on companies of Karachi Stock Exchange in 2004–2009.

Most studies found a negative relationship between CEO duality and financial structure. Bodaghi and Ahmadpour (2010) found that CEO duality does not significantly influence corporate financing behaviour. A study conducted by Agyei and Owusu (2014), indicated that there was no significant impact of CEO duality on debt-to-equity ratio. The result shows a negative relationship between CEO duality with leverage decision.

In an empirical study by Abor (2007), the result explained that there is a negative relationship between CEO duality and leverage decisions. Consistent with Li, Yue, and Zhao (2009), the data show that when CEO acts as a chairman of the board, the duality could minimize the information costs and control costs. As a result, CEO duality or dual leadership is more effective than a separate leadership. Moreover, Fosberg (2004) claims that firms with duality leadership have high debt-to-equity ratio. The possible reasons for this is dual leadership can mitigate agency conflicts. Thus, firms with CEO duality have high accessibility to outside financing.

Theoretically, agency problems could be reduced by separating the function of decision management and decision control. Boyd (1995) argued that the duality role provides broader power, control, and authority to the CEO. There exist advantages and costs for both duality and separation of powers. Hence, there is an insignificant

relationship between role duality and capital structure since duality can be worthy and beneficial for some companies but could not be valuable for others (Brickley, Coles, & Jarrell, 1997). Therefore, the third hypothesis is formulated as follows:

H3: There is a negative significant relationship between CEO duality and companies' financial structure decision.

Tenure of CEO

CEO with long tenure normally is more likely to entrench their positions because they have more time to create alliance and strengthen power. Hence, CEO tends to control the board and internal mechanisms that can pursue their own benefits rather than principals' interest. Past studies (Wen et al., 2002) indicated that CEO's tenure affects the CEO's control over internal decision as a result of the extension in tenure length. For this reason, CEO and directors choose low leverage rather than high debt to mitigate high fixed interest payment. Wen et al. (2002) examined the relationship between corporate governance and capital structure in 628 Chinese listed firms and found that board composition and tenure of CEO has a significant relationship with the company's leverage.

Rakhmayil and Yuce (2009) hypothesized that CEO with longer tenure had more experienced and consequently has higher competence. The result showed that there was a significant negative relationship between CEO tenure and leverage. This is because, when the CEO has more experience, the CEO will be cautious of bankruptcy risk if relied heavily on debt. Furthermore, using higher debt could lessen the capacity of company to borrow during company's financial crisis. The result was supported by Gill, Mand, Sharma, and Mathur (2012) where the study proved that CEO tenure has a negative relationship with financial structure.

From the agency theory perspective, Hill and Phan (1991) and Shen (2003) suggest three reasons for CEO with longer tenure could become entrenched. Firstly, the reason for increasing of CEO tenure is because of good performance record. Secondly, CEO with longer tenure could influence board composition through the nomination of higher number of new board members indicating a loyal board and concerned to the CEO. Thirdly, due to longer tenure, CEO may increase the power and gain the control over internal information systems and procedure. Control over procedures and information systems could afford the ability of CEO to reserve appropriate information or control the board agenda. From the above argument, the CEO tenure is hypothesized as below:

H4: There is a negative significant relationship between tenure of CEO and companies' financial structure decision.

Ownership Structure

The ownership structure of this study is represented by institutional ownership that consists of insurance companies, pension funds, and professional fund managers. The importance of having institutional investors and private investor is that they mostly hold shares on behalf of individuals that can help to achieve the long-term financial growth. Coffee (1991) confirmed that institutional investors can monitor the management to reduce the agency costs. Bodaghi and Ahmadpour (2010) found that institutional ownership has association with capital structure which is constant with corporate governance philosophy. The positive relationship was caused by the effective monitoring and decay of the agency costs and managerial opportunism. Driffield, Mahambare, and Pal (2007) analysed data of different ownership structure among listed companies in Indonesia, Korea, Malaysia, and Thailand for the period of 1994–1998 and found that ownership effects is not only depending on cash flow control separation but also on: (i) separation of management control and (ii) enforcement and rules regulation in a certain country defining investor's protection.

The studies are done by Tong and Ning (2004) and Grier and Zychowicz (1994) shown an adverse relationship between institutional ownership and firms' leverage. The results define that firms with high leverage will be facing a financial problem in the future. Besides, due to stringent influence of institutional ownership, better monitoring and interference, institutional ownership will raise internal fund generation and automatically will reduce external borrowings. Furthermore, Jensen (1986) claims that institutional ownership could decay the agency costs through monitoring the company's performance and maintains the shareholders' interests. Shleifer and Vishny (1986) also prove that institutional ownerships monitor the board (decision-maker) performance effectively. As a result, it shows a negative association between institutional ownership and firms' debt level. Therefore, this study formulates the hypothesis as below:

H5: There is a negative significant relationship between institutional ownership and companies' financial structure decision.

Research Methodology

This study examines data from 2013 annual reports which are randomly selected (Agyei & Owusu, 2014; Ho & Taylor, 2013) from 100 non-financial and non-insurance of public listed companies in Bursa Malaysia.

Measurements and Variables

Board size (BS) is measured by the total number of board members (Wen et al., 2002; Abdul Rahman, & Tamsir, 2011). In this paper, a log specification is used to measure the board size. The total director's remuneration is measured in a log specification. Adopting the Abdul Rahman and Tamsir (2011) measurement on CEO duality, this study labelled the company with CEO duality as 'Yes' and labelled as 'No' if the position is held by a different person. 'Yes' is presented as 1 while 'No' is presented as 0. The tenure of CEO (CT) referred to the period of the year the CEO holds main position as a CEO in the company (Wen et al., 2002). This study measures the CEO tenure by the total number of years employed as the CEO in the company. Institutional ownership is measured by percentage of shares held by institutional ownership consists of insurance companies, pension funds, and professional fund managers over total shares as disclosed in annual reports (Hasan & Butt, 2009), which is measured in the log specification. The financial structure decision is the dependent variable of this study, using leverage as a proxy. Leverage is measured by using debt-to-equity ratio (Shyu, 2013; Shukur & Dev, 2012; Hirota, 1999). All variables data were keyed-in using Statistical Package for Social Science (SPSS).

Data Analysis

Regression Analysis

A multiple regression was carried out in order to examine the relationship between corporate governance mechanisms and financial structure decision of Malaysian's firms. Several diagnostic tests were performed prior to the multiple regression analysis. The summary of the multiple regression results is presented in Table 1.

Based on the results in Table 1, the overall explanatory factors of financial structure decision were statistically significant at 1% significant level with R-squared of 17.9% (F-value = 3.386; p-value = 0.005). The result suggested that the 17.9% variance in financial structure could be explained by board size, directors' remuneration, CEO duality, CEO tenure, institutional ownership, and firm's size. The result of R^2 is almost similar to Hussainey's (2007) study on corporate governance mechanisms and capital structure in UAE. The R^2 for this study is, i.e. 0.126 is lower than many others studies (Hirota, 1999; Shukur & Dev, 2012) that employed debt-to-equity ratio to measure the financial structure. Hirota (1999) obtained R^2 of 0.620 on all sample of capital structure of Japanese firms, whereas Shukur and Dev (2012) produced R^2 of 0.4618 on a study examining 54 Bursa Malaysian property companies. This difference indicates that Japanese corporate governance practices are better than Malaysian practices. However, the differences in R^2 could be due to differences in dataset and the theoretical framework used in each study.

Table 1 Regression result based on normal scores (transformed)

	Coefficients (Beta)	*t*-statistics	*p*-value
(Constant)		−4.318	0.000
BS	0.058	0.497	0.620
LgDR	0.257	2.389	0.019**
CD	0.016	0.160	0.873
CT_NEW	0.087	0.853	0.396
IO_NEW	0.084	0.788	0.433
LgFS	0.192	1.938	0.056*
R^2	0.179		
Adj. R^2	0.126		
F-statistics (*p*-value)	3.386 (0.005)***		
Df	(6.93)		
N	100		

Note *** Significant at 0.01 level, ** Significant at 0.05 level, * significant at 0.1 level

Moreover, this regression results revealed that there was a positive significant relationship between directors' remuneration and debt to equity at a 1% significance level with a *p*-value = 0.019. This indicates that the increase in directors' remuneration could influence the decision of financial structure. Therefore, hypothesis 2 is supported. This hypothesis is supported by agency theory which suggested that to reduce aberrant activities among managers; an appropriate incentive could motivate managers to serve the principal's interest. This result is consistent with Ortiz-Molina's (2007) study which found the positive relationship between financial structure and directors' compensation. On the other hand, the results contradict with past studies, i.e. Abdul Rahman and Tamsir (2011), Wen et al. (2002), and Brenni (2014) which revealed the directors' remuneration is not influenced by the financial structure decision.

In addition, the result proved that the firm's size has a moderate significant relationship with debt to equity at *p*-value = 0.056. The results indicate that the firm's size is influencing Malaysian companies financial structure decision. Similar to Md-yusuf et al.'s (2013) study, the larger company will need more financial supports to operate the business and thus required higher debt. However, results are contradicted with Rajan and Zingales (1995) and Booth, Aivazian, Demirguc-Kunt, and Maksimovic (2001) studies, which found that large company prefers to evade debt and choose internal resources.

Table 1 showed the *t*-statistics is 0.497 and *p*-value at 0.620 for board size, i.e. found to be not significantly but positively related to the financial structure decision. The results are aligned with agency theory which predicts that higher board size prefers to use debt as operation resources. Hence, hypothesis 1 is not supported. CEO duality with a *p*-value at 0.873 is not significantly related to the financial structure decision. This is not in line with agency costs suggestion where the separation power

of CEO and Chairman could mitigate the agency problems. The results concur with Emamgholipour et al. (2013) and Nazir (2012) which suggest that duality role could influence the financial structure decision. Thus, hypothesis H3 is not supported.

Besides, CEO tenure attained *t*-statistics = 0.853 and a *p*-value = 0.396, also expressed an insignificant positive relationship, i.e. differs from the hypothesis prediction. Likewise, Berger et al. (1997) and Wen et al. (2002) found that CEO tenure will affect the CEO control over internal decision (e.g. financial structure). Therefore, the result does not support the agency theory that proposes CEO with more experience (longer tenure) will be more cautious of bankruptcy risk, thus, CEO will evade relying on debt. Hence, hypothesis 4 is also not supported.

The same result was found for institutional ownership where *t*-statistics = 0.788 and *p*-value = 0.433. An insignificant positive relationship is found between the institutional ownership and financial structure decision. The result indicates that the higher number institutional investors could increase the level of debt, which is, not in line with the agency theory. Agency theory suggests that institutional investors prefer to invest in low leverage firm. Besides, due to high monitoring and interference by institutional ownership, the external borrowings could be reduced. This in line with the Bodaghi and Ahmadpour's (2010) study which stated that institutional ownership has an association with the capital structure. Thus, hypothesis 5 is not supported.

Conclusion, Limitations, and Future Research Opportunities

The agency theory is employed in this study to examine the impact of the corporate governance mechanism on the financial structure decision to mitigate the agency costs. Only directors' remuneration and firm's size are having significant relationship with the financial structure decision. Board size, CEO duality, CEO tenure, and institutional ownership do not have significant relationship with the financial structure. Commonly, corporate governance is developed to reduce the agency costs and ensuring the separation of ownership and management to protect the shareholder's rights. This aligns with corporate finance theories, which suggest that financial structure is one of the elements that contribute to the agency cost, while corporate governance is a tool that can mitigate the agency issues.

This study is without any limitations. Based on the current study, the sample size only employed a total of 100 randomly selected companies listed in Bursa Malaysia for the year ended 2013. Compared to the total number of population of public listed companies in Malaysia, the results produced by this study could not be employed to generalize the overall performance of public listed companies in Malaysia. Hence, future research should analyse more companies to enable the generalizations of findings.

This study extracted the data from companies' annual reports for the year ending 2013. To be more comprehensive, the data could be supported by interviews with the company's personnel. Different proxy used in measuring the financial structure decision could be the limitation of this study, which allows difficulties to compare

and determine the reliability of the results. Prior studies used the debt ratio to measure the financial structure, whereas this study is using debt-to-equity ratio.

This study has taken up a recommendation by Abdul Rahman and Tamsir (2011) to examine the different ownership other than managerial ownership. This study employed an institutional ownership as a proxy for ownership structure as part of the corporate governance mechanisms. Future studies may consider other types of corporate governance mechanisms that can affect the financial structure.

Most studies employed an agency theory to predict the relationship between corporate governance and financial structure. The results from this study have indicated that corporate governance mechanisms (CEO duality, CEO tenure, and institutional ownership) are not supporting the agency theory's tenet on capital structure. For that reason, future research could extend this study by using other theories, such as Modigliani and Miller theory (MM theory), pecking order theory, trade-off theory, stewardship theory, or resources-based theory to explain the relationship between corporate governance mechanisms and financial structure. It is hoped that those theories could contribute to better results than agency theory in explaining the financial structure. Different theory is assumed to have some impact on the financial structure decisions. The research is focussing on data in 2013. Future studies may consider analysing the longitudinal data, i.e. more than a year. The results will show the trend of financial structure decision over the periods. This is because longitudinal studies provide cause and effect relationships. The environmental changes may also be taken into account if conducting the longitudinal study. Lastly, to enhance the understanding of financial structure, future research may investigate on specific industry, or making comparison between two industries to determine the effect of company's financial structure.

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Zuria Juhari is a lecturer, working at the Faculty of Business Management & Professional Studies, Management & Science University, Sabah branch known as MSU College Sabah, Malaysia. She is a holder of Master of Accountancy from the Universiti Teknologi MARA (UiTM), Malaysia.

Corina Joseph is an Associate Professor in Accounting. She graduated from Curtin University, Australia. Her Ph.D. thesis is on 'Sustainability Reporting on Malaysian Local Authority Websites'. Corina's research interest is in Public Sector Accounting and Governance, Corporate Governance, Sustainability, and CSR Reporting and Integrity Framework. She publishes several articles in several international refereed journals. She serves as Editorial Board Members at several international journals. She is now working at the Faculty of Accountancy, Universiti Teknologi MARA, Sarawak, Branch, Malaysia.

The Relationship Between Corporate Governance Mechanisms and Firm's Performance

Shahrina Liza Salisi and Corina Joseph

Introduction

Corporate governance has encouraged transparency and accountability. This can be seen from the issuance of the Malaysian Code of Corporate Governance (MCCG) 2000, where all the listed companies in Bursa Malaysia are required to disclose the corporate governance practices in the annual report by virtue of paragraph 15.26 of the KLSE Listing Requirements. The roles and function of corporate governance is essential in setting up the good corporate governance framework for an organization. This is due to the fact that good corporate governance framework provides mechanisms and recommendations to ensure a more effective board of directors which indirectly enhance the company's performance. The separation of ownership (principal) and management control (agent) leads to agency problem (Jensen & Meckling, 1976). Thus, in order to minimize the conflict of interest between the principal and agent, there were various mechanisms being implemented to control the agency cost. Corporate governance, which is consisting of internal and external governance mechanisms, is suggested to curb the agency problem. Due to the major corporate collapses in UK, USA and Malaysia, the establishment of corporate governance guideline is seen as an important effort to enhance the efficacy of corporate governance structures.

Due to its apparent importance for the economic health and the public interest in general, Malaysia's authorities have established the corporate reform on rules and regulation. The first reform starts with the establishment of the Finance Committee in 1998 to conduct a detailed study on corporate governance. Then, the Malaysian Code of Corporate Governance (MCCG) in 2000 was established, followed by the KLSE

S. L. Salisi (✉)
Universiti Teknologi MARA (UiTM) Sabah, Kota Kinabalu, Malaysia
e-mail: bearblue_20@yahoo.com.sg

C. Joseph
Universiti Teknologi MARA (UiTM) Sarawak, Kota Samarahan, Malaysia

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Listing Requirements issued in 2001, which introduced a new section on corporate governance reporting. Consequently, MCCG 2007 and MCCG Blueprint 2011 were established. Then, the latest one known as MCCG 2012, which strengthen on the board structure and composition and recognize the roles and responsibilities of the board of directors, has shown that Malaysia had taken the corporate governance reform as a serious matter.

The efforts of Malaysian authorities in improving the corporate governance guideline have received a remarkable achievement when Malaysia was placed at top ten for 'ease of doing business' in the world. In a survey conducted by the World Bank *Doing Business,* Malaysia has ranked at 6th place out of 189 countries in 2014 which shows a jump up to the top ten positions compared to 2013 at the 12th place. This indicates Malaysia has improved its regulatory framework and the processes for investors to start a business and dealing with the authority.

The effectiveness of corporate governance mechanisms influence on the firm performance varies from one study to another. The poor corporate governance practice has impacted on the firm performance. The institutional investors in Malaysia particularly are willing to pay premium of more than 22% for well-governed companies (Abdul Wahab, How, & Verhoeven, 2007). Corporate governance is an essential practice because it reflects how efficient the firm in utilizing the resources, assisting the firms and the economy in attracting capital investment, improving investors and creditors confidence and increasing the firm awareness on the social needs and expectation, which indirectly enhance long-term performance of the firm (Gregory & Simms, 1999).

Besides the financial crisis, Transmile Group Berhad and Megan Media Bhd cases have been labelled as Malaysian mini-Enron financial scandal due to the big amount and the involvement of the company's top management in financial statement fraudulent (Abdul Hamid, Shafie, Othman, Wan Hussin, & Fadzil, 2013). The failure of big-name organizations, such as Enron, WorldCom and Xerox, has shown as lack of corporate governance which unfavourably affect the country's market the public confidence on the integrity of financial reporting (Che Haat, Abdul Rahman, & Mahenthiran, 2008). Poor corporate governance leads to companies' suffering from leverage (Fraser, Zhang, & Derashid, 2006), lack of transparency, financial disclosure and accountability (Mitton, 2002) and poor protection on minority shareholder (Claessens, Djankov, Fan, & Lang, 1999).

Thus, this study aims to examine the relationship between the corporate governance mechanisms with firm performance. The existence of corporate governance mechanisms aims to overcome the agency problem faced by one organization. The agency costs occur when the interest of the manager and the shareholders is misaligned (Jensen & Meckling, 1976), and the managers may misappropriate the resources supplied by the shareholders for their own benefits. It is advanced here that good practice among directors may increase the value of the firm and as well indirectly enhance the shareholders' wealth.

Board of directors is regarded as a team of individuals who have three fiduciary duties: the duty of care, the duty of obedience and the duty of loyalty with the main objective to ensure the shareholders' interest is protected. Due to its monitoring role

in the firm, board of directors may protect the firm from harmful behaviour and fraud which might otherwise be committed by the top management. To determine the effectiveness of the board in safeguarding the shareholders' wealth and enhance firm's performance, this study will provide another empirical evidence by extending the study by Abdullah (2004). The difference between this study and previous study is the addition of two variables to be tested: (1) board size and (2) board of directors' remuneration and using data taken from annual reports for the year 2013, following the MCCG 2012. Furthermore, previous study used the financial ratio to measure the firm performances while this study uses both accounting and market measures. Therefore, examining the strength of the board of director's functions and characteristics is significant to this study and may contribute to the existing body of knowledge on corporate governance.

Corporate Governance and Firm Performance

The existence of corporate governance mechanisms is to make sure the investor will receive returns from their investments (Shleifer & Vishny, 1997). The failure of Malaysian companies, for example Transmile Group Berhad and Megan Media Bhd, has been considered as a wake-up call to the needs of a better framework and guidelines to promote transparency and accountability among Malaysian companies. There is various literature on corporate governance and firm performance. A literature review from previous studies has indicated corporate governance characteristics, such as board size (Amran & Che Ahmad, 2011; Coles, Daniel, & Naveen, 2008; Germain, Galy, & Lee, 2014), CEO duality (Abdullah, 2004; Daily & Dalton, 1993; Rechner & Dalton, 1991), directors' compensation (Conyon, 1995; Conyon & Peck, 1998; Ghosh & Aggarwal, 2011), composition of independent directors (Crespí-Cladera & Pascual-Fuster, 2014; Petra, 2005; Rosenstein & Wyatt, 1990) has significant relationship with firm performance. Firm performance can be measured by accounting measures and market-based measures.

Underpinning Theory: Agency Theory

Agency theory is the possible solution to resolve conflict that arises between the principals and agent due to asymmetric information (Eisenhardt, 1985). Agency theory concern is to resolve two problems which occur in any agency relationship. One is when the desire of the principal is conflicting with the agent and the second one is the difficulty or expensive cost for the principal to verify what actually the agent is doing (Eisenhardt, 1989). The separation of ownership and control leads to agency cost where the managers fulfil own interest without having consideration of the shareholders' wealth (Jensen and Meckling, 1976). The agency cost occurs when the interest of the agent is not aligned with the principal. Furthermore, it is believed that

the separation between the decision control and decision management may reduce the agency costs and lead to higher performance. Thus, the presence of board of directors is to monitor the management and protect the shareholders' wealth. Higher level of executive compensation, adoption of poison pills, payment of green mails and awarding golden parachutes are among agency problems encountered when the agent fulfils their own interest (Boyd, 1994; Kosnik, 1987). From the agency theory perspective, independent directors will promote better firm performance. The theory assumes that the independent directors are individualistic, opportunistic and self-serving (Ramdani & Witteloostuijn, 2010). Weisbach (1988) stated that independent directors are not affiliated with the management. The independent director is expected not to pursue private interest.

In relation to the leadership structure, agency theory suggests that CEO and chairman positions should be held by different person to differentiate between the operational responsibility and control responsibility. The separation between CEO and chairman responsibility may develop effective monitoring roles by the board. There will be a check and balance to control the management, and this leads to better performance. By having the CEO as the chairman of the board, it is likely to give opportunities for the CEO to take control of the board's decision. By giving the CEO, the power to initiate his own strategies reflects on weak decision control by the board, which, in turn, leads to less performing firm.

Directors' compensation package could be derived from salaries, fees, bonuses and equity-based. Financial incentives have never failed to attract directors to pursue the management monitoring decisions. Financial incentives are one of the internal control mechanisms to align the interest of shareholders and the management (Ghosh & Aggarwal, 2011). From the perspective of agency theory, compensation could be used to reduce the agency conflict (Haron & Akhtaruddin, 2003). Jensen and Meckling (1976) further stated in their research, direct ownership is the most powerful link between directors' rewards and corporate performance.

Research Framework

A research framework could form a basis for the development of hypotheses in any research. This study employed the following research framework (see Fig. 1) as translated from past studies and theoretical arguments:

Hypothesis Development

In this section, the hypotheses on several corporate governance mechanisms—board of directors' characteristics, such as board independence, CEO duality, board size and board of directors' remuneration—are tested on the firm's performance of public listed companies in Malaysia using agency theory.

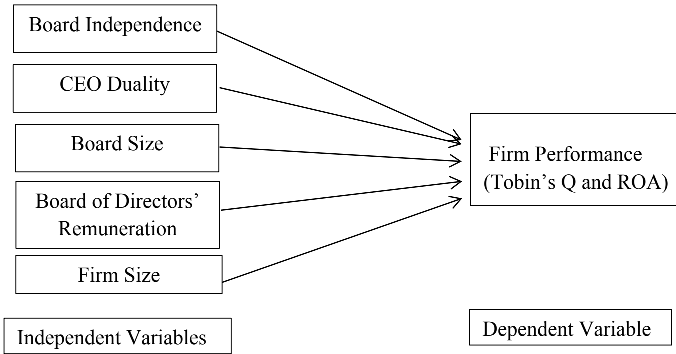

Fig. 1 Research framework

Board Independence

Bursa Malaysia Revamp Listing Requirement required one-third of the board members to be independent directors. Abdul Rahman and Mohamed Ali (2006) found on average, Malaysian companies have complied with the requirement. Agency theory predicts that the effectiveness of independent director may reduce the agency problem. Thus, the agency theory suggests that the board of directors should be dominated by independent directors. This is because, the independent directors could add value to the firm by lending experience and monitoring service (Fama & Jensen, 1983). The outside directors are also more objective, independent and able to influence the boards' decision (Kosnik, 1987) which promotes better firm's performance. On the other hand, inside directors are better informed and know the companies very well, which, in turn, is able to make decision effectively compared to independent directors (Ramdani & Witteloostuijn, 2010) from the perspective of stewardship theory.

Even though agency theory suggests the independent directors should dominate the board composition to enable effective monitoring, there is a drawback of having high independent directors on the board. There is an argument that the independent directors can create stifling strategic actions (Goodstein, Gautam, & Boeker, 1994). Petra (2005) found the presence of independent directors is not affecting the firm performance. The US study by Bhagat and Black (2002) found a negative relationship between the proportion of outside directors and corporate performance (Hermalin & Weisbach, 1991; Petra, 2005). In firm's family ownership scenario, Ibrahim and Samad's (2011) study shows a significant negative relationship between the composition of outside directors and firm performance when measured by Return on Assets (ROA). Amran and Che Ahmad (2011) found similar findings, i.e. lesser number of independent directors to enhance the family's firm performance.

However, there is a positive significant relationship between the compositions of outside directors with firm performance based on Tobin's Q and ROA. Similar to Zahra and Pearce (1992) findings on the 450 firms from *Fortune 500*, there is a positive

significant relationship between the proportion of outside directors and firm performance using accounting measures. The positive significant relationship between the proportion of independent directors and firm performance implies that the involvement of independent directors is needed in the process of preparing financial reports (Beasley, 1996). Based on the arguments, it is hypothesized that:

H1: There is a positive relationship between board independence and firm performance.

CEO Duality

The MCCG 2012 states that the position of CEO and chairman should be held by different individuals. From the agency theory perspective, when the same individuals hold two positions, CEO and chairman, there will be an opportunity for the CEO to dominantly influence the board's decision. The CEO duality is argued to weaken the board's independence and monitoring function; that is, the management becomes ineffective which leads to less performing firm. Abels and Martelli (2013) uncover the combination of CEO and chairman position of top 500 companies in the USA which had fallen to third place in 2010 compared to 2008. This is because, the companies desire to enhance the corporate transparency and independence which is consistent with the agency theory.

However, there is evidence that companies with CEO duality perform better (Donaldson & Davis, 1991; Ramdani & Witteloostuijn, 2010) in an average-performing firm. This is because, average-performing firm needs strong leadership and unity of command. In addition, the power held by one person in top position leads to better decisions and improvement. Using data of 141 companies of Fortune 500, Rechner and Dalton (1991) found the accounting measures are correlated with CEO.

Contrarily, Krause and Semadeni (2013) had introduced three different types of separation, and the separation types give different effect to the firm performance. The study focused on the 'when' and 'how' the separation should take place rather than 'whether'. The study found that the separation of CEO and the chairman positively impacts the future firm performance when the current performance is weak. The study supports the agency theory which suggests the separation of the CEO and chairman positions leading to a better firm performance.

Agency theory further tested in Amran and Che Ahmad (2009); the study of 896 public listed companies in Malaysia found that CEO duality is not significantly related to the firm's family value. Using market and accounting measures, Haniffa and Hudaib (2006) found there is no significant relationship between duality and firm performance measured by market indicator and, however, found there is a significant relationship related to accounting measure in a negative direction. Abdullah (2004) found that CEO duality is not related to firm performance in Malaysia. Rao, Baliga and Moyer (1996) found there is no significanct difference in the firm performance

which practises duality or separation leadership. Therefore, based on the above arguments, the second hypothesis is derived:

H2: There is a negative relationship between CEO duality and firm performance.

Board Size

Board size refers to the number of directors on the board. Evidence on the relationship between board size and firm performance is mixed. There are two perceptions on the effect of board size on firm performance. Those who are in favour of smaller board argue these boards perform better due to faster collective decision and more efficient (Waqar, Rashid, & Jadoon 2014). The proponents of larger board size argue that diversified boards would help the company to secure resources and indirectly perform better (Zahra & Pearce, 1992).

Small firms are performing better (Yermack, 1996). Board with more than seven or eight directors is less likely to perform effectively due to communication and coordination problems, which consequently enable the CEO to take control (Jensen, 1993). Amran and Che Ahmad (2011) found the average size of the board is around eight people per board which supports the study by Jensen (1993). Another study by Kumar and Singh (2013) in India found that smaller board is associated with firm performance.

On the other hand, larger board is claimed to have a strong indication to the firm performance due to the available capabilities and skills; more resources provide more strategies solutions and enhance problem-solving capabilities (Haleblian & Finkelstein, 1993; Zahra & Pearce, 1989). The agency theory attracts the best possible solution to align the interest between the principal and agent. Thus, by putting diversified business field of board members on board in one company could contribute to fruitful discussion and high-quality decision-making which will benefit the shareholders (Coles, Daniel, & Naveen, 2008). The separation of ownership and control would be difficult for the principal to verify and monitor what the agent is actually doing. Lack of information and uncertainty could be solved with having larger board. Germain et al. (2014) identify the determinants for board structure in Malaysia and found that board size is correlated with the operation level of the firm. The larger complex firms required larger board members to provide more advice and access to information and resources. In relation to firm performance, the study found a negative relationship between board size and market to book value.

Coles et al. (2008) found there is a positive significant relationship between the board size on Tobin's Q for diversified, large and debt financing firms. Cheng (2008) further examines the association between the larger board size and the corporate performance. The study found that larger board is less extreme and takes times to reach consensus. The effect of agency problem is that larger board size allows CEO to influence and control the board's decisions (Jensen, 1993). Hence, it is expected

that larger board size will enhance the firm performance of public listed companies in Malaysia, and therefore, the third hypothesis is derived:

H3: There is a positive relationship between the board size and firm performance.

Board of Directors' Remuneration

To avoid agency cost, the directors should be rewarded based on their performance, which is suggested by agency theory. There is an argument that the directors are paid excessively and not related to firm performance (Andjelkovic, Boyle, & McNoe, 2001). Haron and Akhtaruddin (2003) found that the larger the firm, the more lucrative will be the remuneration package received by the board of directors. Studies by Conyon and Peck (1998) and Ghosh and Aggarwal (2011) found that director remuneration does not have any significant relationship with the firm's profitability. Similarly, a study by Veliyath (1999) found that the firm performance is not a significant determinant of executive pay. Abdullah (2006) investigates the roles of firm performance in determining director's remuneration focusing on the distressed companies and healthy companies. The study found that profitability (as measured by ROA) is not associated with director's remuneration. However, the firm's growth and the size positively influence the level of director's remuneration.

Crespi and Gispert (1998) empirically analysed Spanish listed companies' financial statements during the period from 1990 to 1995 and found that there is a positive relationship between board remuneration and company performance. The changes in company performance lead to changes in board remuneration. Agency relationship is when the principals engage the agent to perform service on behalf of the principals, which involve delegating some decision-making authority to the agent. However, the agent is not always acting in the best interest of the principal. In order to limit the disappearance of the principal's interest, the establishment of appropriate incentives for the agent could deter the aberrant activities (Jensen & Meckling, 1976). Hence, this study proposes the fourth hypothesis:

H4: There is a negative relationship between director's remuneration and firm performance.

Research Methodology

The 100 companies' annual reports were randomly selected from the Bursa Malaysia website for the financial year ending 31 December 2013, following the introduction of MCCG 2012.

Measurement and Variables

The dependent variable employed in this study is firm performance. There are two measurements considered in this study as a proxy for firm performance: market return and accounting return. The measurements are Tobin's Q and Return on Assets (ROA). Tobin's Q (market return proxy) is derived from market value of the ordinary shares plus book value of the liability divided by total assets of the company. The higher the value of Q means the corporate governance mechanisms are effective for the firm (Weir, Laing, & McKnight, 2002). Previous study used Tobin's Q as the measurement of firm performance (Amran & Che Ahmad, 2011; Che Haat, Rahman, & Mahenthiran, 2008; Haniffa & Hudaib, 2006; Kumar & Singh, 2013; Yermack, 1996). Furthermore, Tobin's Q is able to explain the role of share market in economy and show the natural company's value as reflected by the share price of the company (Gunawan & Budiarjo, 2014).

Accounting return measure, such as ROA, is used in this study to measure the firm performance. ROA is used in this study because ROA is related to management's ability to utilize the company's resources efficiently, which belongs to shareholders. ROA derived from net income is divided by total assets. The higher the ROA shows the company is effective in utilizing the company's assets in serving the shareholders' interest. Previous studies used this performance indicator on firm performance (Abdullah, 2004; Coles et al., 2008; Daily & Dalton, 1992; Haron & Akhtaruddin, 2003; Ujunwa, 2012).

This study measures the board independence composition by the number of independent or outside directors on the board (Abdullah, 2004; Amran & Che Ahmad, 2011; Coles et al., 2008). CEO duality is where the CEO also serves as the chairman of the board. CEO duality is measured by binary variable (Abdullah, 2004). If a CEO is also chairman of the board, the indicator equals to one, and zero, if otherwise. Board size is defined as a number of directors on the board. Board size is measured by the number of board members on the board consistent with several past studies (Amran & Che Ahmad, 2009, 2011; Coles et al., 2008; Ibrahim & Samad, 2009). The remuneration in this study is defined as salaries, allowance, fees, bonus and benefit in kind (Conyon & Peck, 1998; Haron & Akhtaruddin, 2003; Main, Bruce, & Buck, 1996). This study includes a control variable, i.e., the firm size, which is expected to influence the firm performance. Prior studies (Haron & Akhtaruddin, 2003; Kumar & Singh, 2013) use total assets to measure the firm's size. This study measures the size by using total assets of the firm.

Results and Discussion

A multiple regression analysis was performed on the firm performance and all its explanatory variables. Several diagnostic tests were performed prior to the multiple regression analysis. This analysis was carried out to examine the relationship between

Table 1 Multiple regression result based on normal scores (transformed)

Variables	Tobin's Q			ROA		
	Coefficient (Beta)	*t*-statistics	*p*-value	Coefficient (Beta)	*t*-statistics	*p*-value
Intercept		3.838	0.000		0.146	0.884
BIND	−0.001	−0.012	0.991	0.175	1.517	0.133
CEODUAL	0.227	2.310	**0.023***	−0.028	−0.286	0.775
BSIZE	−0.041	−0.323	0.747	0.175	1.350	0.180
lgDREM	−0.250	−2.298	**0.024***	0.012	0.111	0.912
FSIZE	0.039	0.393	0.695	−0.170	−1.717	**0.089****
R^2	0.126			0.110		
Adj. R^2	0.080			0.062		
F-statistics (*p*-value)	2.711 (0.025)*			2.313 (0.050)*		
Df	(5, 94)			(5, 94)		
N	100			100		

Note *Significant at 0.05 level, **Significant at 0.10 level

corporate governance mechanisms and firm performance measures by Tobin's Q and ROA. The summary of the multiple regression results is presented in Table 1.

Regression Results Based on Market Measure

Table 1 presents the multiple regression results. The results reveal that CEO duality is positively significant with Tobin's Q at 5% significant level ($p = 0.023$). This result supports findings by Ramdani and Witteloostuijn (2010) and Sridharan and Marsinko (1997), where there is a significant positive relationship between CEO duality and firm performance. This is because CEO has all the information to be disclosed to the members of the boards, and CEO duality prevents the conflict of interest with having a strong consistent leadership. Hence, Hypothesis 2 which predicts negative relationship between CEO duality and firm performance is not supported. Thus, this result does not support the agency theory that suggests the separation between the CEO and the chairman to reduce the agency problem and consequently promote the effective monitoring.

This result may be due to the fact that about 70% of the firm is family-owned in Malaysia (Claessens, Djankov, & Lang, 2000). The CEO of the company, who is also holding the chairman position, is perceived to manage the company better than non-family firm, lower agency costs, mitigate the agency problem and duality leadership lead to higher performance (Amran & Che Ahmad, 2011; Ibrahim & Samad, 2011). Thus, this result possibly supports the stewardship theory where the

theory predicts that CEO duality performs better than firms without duality (Ramdani & Witteloostuijn, 2010). In Dalton, Daily, Ellstrand, and Johnson's (1998) study, when referring to stewardship theory, the desired objectives are often hard to achieve when the roles of the CEO and the chairman are performed by different people.

However, this result contradicts with Haniffa and Hudaib (2006), Ibrahim and Samad (2011) and Schmid and Zimmermann (2010) where the studies found there was insignificant relationship between CEO duality and market-based measures. The possible interpretation was the agency costs associated with a combined function are mitigated by a higher incentive alignment of the CEO/Chairman through an adequate level of managerial shareholding (Schmid & Zimmermann, 2010). Furthermore, the CEO duality has no impact on the market performance due to the varying impact of CEO duality across industries (Elsayed, 2007).

Besides that, board of directors' remuneration also has an inverse significant relationship with Tobin's Q. The significant level is at 5% with ($p = 0.024$). This result contradicts with findings by Main et al. (1996) using the market measure—share performance to examine the executive package which can affect an alignment of interest between management and the shareholders. Strong positive significant relationship was found between CEO remuneration package with the share performance but not in the directors' remuneration package.

However, this result supports findings by Jensen and Murphy (1990) where the study found a significant relationship (positive) between directors' remuneration and stock return, as a proxy for firm performance. Ghosh (2003) also found the directors' remuneration is significant and gives effect to the firm performance. The control variable, i.e. firm's size (FSIZE), is found to be insignificant and not correlated with the market measure Tobin's Q. Hence, this result supports the predicted relationship in Hypothesis 4, where there is a negative relationship between the board of directors' remuneration and firm performance. Hypothesis 4 is supported.

The board independence (BIND) in this study is found to be not significantly related with the Tobin's Q ($p = 0.991$), and the result supports the findings of Amran and Che Ahmad (2011), Cheng (2008) and Petra (2005). The similar result is also found in Miwa and Ramsayer's (2005) study where the findings suggest that the discretionary role of the outside directors (independent directors) in controlling the opportunistic managerial behaviour was unclear. Independent directors seem to be independent in form rather than in substance (Mak & Kusnadi, 2005). This result does not in line with the agency theory perspective on the larger proportion of independent directors that will promote better firm performance through effective monitoring.

The board size (BSIZE) is not significantly related with the market measurement (Tobin's Q) where the p-value is 0.747. This result is contrary to the findings by Amran and Che Ahmad (2009), Haniffa and Hudaib (2006) and Coles et al. (2008). The insignificant relationship is probably due to high compensation cost and incentives for the directors to discharge director's roles. However, this result supports the findings by Amran and Che Ahmad (2011), Mak and Kusnadi (2005) and Yermack (1996). The studies suggest that the market perceives larger boards which are less effective than smaller group in making decision and tend to be symbolic rather than being part of the operation process and one size of the board does not seem to fit in enhancing the

firm performance. Thus, the monitoring ability by the board of directors as suggested by agency theory is not parallel with this result. Hence, Hypothesis 3 is not supported.

Regression Results Based on Accounting Measure

The accounting measure by ROA result shows board independence (BIND), CEO duality (CEODUAL), board size (BSIZE) and board of directors' remuneration (LgDREM) are not significantly related with the proxy for firm performance—ROA. The result reveals only the firm size (FSIZE) is significantly related with ROA.

Firm size is found to be moderately significant with ROA at 10% significant level ($p = 0.089$) however not significant with Tobin's Q ($p = 0.695$). This result is consistent with findings by Amran and Che Ahmad (2011) and Ibrahim and Samad (2011). This may be due to the fact that the larger firms are facing less difficulty in getting access to credit for investment, and this was depicted in the firm's financial report, qualified human capital and more diversified (Yang and Chen, 2009). However, larger firms which are under the manager's control may pursue self-interest goal, and therefore, profit maximization could be exploited by the managers for their own benefits, such as better pay and stock options (Jónsson, 2007).

The board independent (BIND) is found to be not significantly ($p = 0.133$) related to accounting performance measure—ROA. The result supports findings by Abdullah (2004), Amran and Che Ahmad (2011), Cheng (2008) and Haniffa and Hudaib (2006) using accounting measure found that the composition of independent directors on the board is not significantly related. Perhaps, the use of accounting measurement might only measure the short-term performance of the firms (Abdullah, 2004; Fosberg, 1989). This result also does not support the findings as suggested by Zahra and Pearce (1992), in which the proportion of independent directors on the board is more capable, highly experienced and having broader external relationship that could assist the companies to secure resources.

Consequently, this result does not support the agency theory which suggests that the independent director is a key to influence the manager to pursue the shareholders interest rather than self-interest. Additionally, this result is not supported by agency theory where the board of directors is dominated by independent directors, which suggest that the independent directors could manage to monitor and control the management effectively in order to reduce the agency problem (Fama & Jensen, 1983; Jensen & Meckling, 1976). However, this result is in line with stewardship theory, in which the board should be dominated by the insider due to better informed and effective decision. Hence, this result does not support the predicted relationship in Hypothesis 1.

Unlike market performance, CEO duality (CEODUAL) is found to be having insignificant ($p = 0.775$) relationship with accounting performance. This result supports findings by Abdullah (2004), Carty and Weiss (2012) and does not support findings by Haniffa and Hudaib (2006).

The relationship between board size and ROA is found to be not significant ($p = 0.180$) which is similar to results when measured by market indicator—Tobin's Q. This result may indicate that larger board is less effective due to free-riding problem and difficult to finalize decisions (Cheng, 2008; Jensen, 1993). On the other hand, this result is contrary to findings by Haleblian and Finkelstein (1993) where the company is benefited from the larger board size due to more suggestions on strategic solutions and problem-solving. This result is not in line with agency theory which suggests that diversified business field of board members on board could lead to fruitful discussion, high-quality decision-making, more capabilities and resources and enhance problem-solving (Coles et al., 2008; Zahra & Pearce, 1989). Directors' remuneration (DREM) is found to be insignificant and not associated with ROA ($p = 0.912$). This result is consistent with findings by Abdullah (2006), Conyon and Peck (1998) and Ghosh and Aggarwal (2011).

Conclusion and the Implications of Study

The main objective of this study is to examine the relationship between corporate governance mechanisms and firm performance, which is measured by market and accounting measures with reference to the MCCG2012. The result from the multiple regression analysis reveals that CEO duality (positively) and directors' remuneration (negatively) were significantly relating to Tobin's Q, while only the firm size is found to be having a significant negative relationship to firm performance using ROA. The result proves that the corporate governance mechanisms influence the firm performance. Additionally, the agency theory is able to support this study and it can be assured that the market indicator is a better proxy for firm performance compared to accounting measure.

This study could assist the High-Level Finance Committee, Bursa Malaysia, and other regulatory bodies to improve on the guidelines on corporate governance in order to improve the performance of Malaysia's public listed companies besides to enhance the capital market. A good corporate governance practice among public listed companies in Malaysia could help to prevent financial fraud and takeovers. Indirectly, the good practices of corporate governance also lead to a transparency reporting.

This study reveals the result which indicates that market indicator using Tobin's Q contributes favourable result compared to accounting measure. This result may contribute to another relevant literature which may consider using market indicator to measure the firm performance. This is because, market indicator is creating value and growth opportunities for future firm performance and less bias compared to ROA, while the ROA is directly related to management's ability to utilize the firm's assets efficiently, which the assets ultimately belong to shareholders. Agency theory perceived that the managers are likely to squander profits, misappropriate earnings and distribute less return for the shareholders. Furthermore, ROA provides information from the past in regard to the company's performance and does not add value.

Limitation of Study

This study is subject to several limitations and weaknesses. First, in regard to the sample selection, this study only employed a total of 100 companies of public listed in Malaysia which is randomly selected from Bursa Malaysia website for the financial year ending 2013. The result derived from this study could not be generalized to the overall performance of public listed companies in Malaysia when compared to the total number of public listed companies on Bursa Malaysia.

The variables used in this study were more focused on the structure of the corporate governance and the impact on the firm performance. To be effective in monitoring, the corporate governance practices are very important. Thus, the data could be supported by interviews or questionnaires to gain insights on the real practices among public listed companies in Malaysia. Furthermore, this study is unable to address the issue on the fairness amount of remuneration since there is an absent of fair remuneration guideline. This study is using total remuneration of directors which had stated in the annual reports, in which the result reveals that board of directors' remuneration is negatively significantly related with firm performance. The results indicate that either the minimum remuneration or maximum remuneration is being tested, and both give effect on firm performance.

Apart from that, the proxies to represent the firm performance were varied across studies. This study had employed different method of measurement for the variables when compared to previous studies. Thus, it is difficult to make comparisons in terms of results.

Recommendation of Future Research

For future research, it is suggested to increase the number of years under study to examine the impact on firm performance. The results may differ across different years if multiple years are considered in this study. Furthermore, in regard to data selected, larger data are required to enhance the result and the understanding of the corporate governance mechanisms. The companies could be categorized into three categories, namely small, medium and large companies to have a more clear picture on which category of companies has the most corporate governance practices and understands the impact on the corporate performance.

Besides that, other variables should be considered to test the impact of corporate governance on firm performance, such as managerial and institutional ownership, the nominating committee, director's qualification and others. Future research also may consider the external corporate governance mechanisms impact on the firm performance.

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Shahrina Liza Salisi is Finance Executive who graduated with the Master of Accountancy from Universiti Teknologi MARA, Malaysia. She is now working at the Department of Strategic Administration (ICT) of Sabah Electricity Sdn. Bhd., Sabah, Malaysia.

Corina Joseph is Associate Professor in accounting. She graduated from Curtin University, Australia. Her Ph.D. thesis is on 'Sustainability Reporting on Malaysian Local Authority Websites.' Corina's research interest is in public sector accounting and governance, corporate governance, sustainability, and CSR reporting and integrity framework. She publishes several articles in several international refereed journals. She serves as Editorial Board Members at several international journals. She is now working at the Faculty of Accountancy, Universiti Teknologi MARA, Sarawak, Branch, Malaysia.

The Influence of Board Structure on GRI-Based Sustainability Reporting: Evidence from Turkish Listed Companies

Merve Kılıç and Cemil Kuzey

Introduction

The global community has become increasingly aware of the social and environmental impacts created by business operations (Kent & Monem, 2008). In response, a growing number of companies have been engaging in socially and environmentally responsible business practices and releasing stand-alone sustainability reports (i.e., corporate social responsibility reports, environmental reports, sustainability reports, etc.). The Global Reporting Initiative (GRI) reporting framework was initiated in order to provide worldwide standardization for these separate corporate reports (Ruhnke & Gabriel, 2013). In recent years, the GRI has become the most widely accepted and used framework to designate the structure of sustainability reports in a comparable and consistent form (Legendre & Coderre, 2013).

Corporate governance is considered to be a crucial mechanism in delineating the rights, expectations, needs, and responsibilities of each stakeholder group of companies (Ho & Wong, 2001). Governance structure is linked to corporate reporting practices because companies with weak corporate governance tend to withhold information from their shareholders (Kent & Monem, 2008). By contrast, companies with a strong corporate governance structure are more willing to disclose information (Ho & Taylor, 2007) and to produce stand-alone sustainability reports (Kend, 2015; Kiliç & Kuzey, 2017). The board of directors is one of the most influential mechanisms of corporate governance structures. Since boards are the ultimate decision-makers, they play an important role in determining corporate decisions and strategies

M. Kılıç (✉)
Independent Researcher, Samsun, Turkey
e-mail: mervekilic.edu@gmail.com

C. Kuzey
Arthur J. Bauernfeind College of Business, Murray State University, Murray, KY, USA

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with respect to non-financial issues (Kuzey & Uyar, 2017), and hence in implementing good practices of corporate social responsibility reporting (Frias-Aceituno, Rodriguez-Ariza, & Garcia-Sanchez, 2013; Michelon & Parbonetti, 2012). In this regard, we attempt to empirically investigate whether board characteristics are associated with the sustainability reporting practices of companies.

The need for international capital to finance high growth rates in emerging economies underlines the significance of strong corporate governance structure with transparent corporate reporting (Uyar, 2011). Although sustainability reporting is voluntary and unregulated in Turkey, sustainability reporting practices have been receiving more attention and recognition from companies, investors and regulators due to increasing concerns about social and environmental matters (Kiliç and Kuzey, 2017; Uyar, 2017). Because Turkey is one of the most important emerging economies, it is significant to analyze the extent and/or factors determining GRI adoption by Turkish companies. The main objective of this paper is therefore to explore the influence of board structure on the propensity of companies to release a GRI-based sustainability report, using a sample of 256 firm-year observations listed on the Borsa Istanbul (BIST), the Turkish stock exchange, throughout the period between 2013 and 2016.

The results indicated that board size as well as the presence of a board committee (i.e., corporate social responsibility, environmental or sustainability committee) enhances the likelihood of releasing GRI-based sustainability reports. However, contrary to expectations, our results revealed that companies with nationality diverse boards are less likely to engage in GRI reporting. In addition, board independence and board gender diversity do not have a significant impact on GRI reporting. Overall findings of this study imply that board structure has a limited influence upon corporate decisions to release sustainability reports using the GRI framework.

This study contributes to the literature in several ways. First, while prior research had mainly focused on sustainability reporting from developed countries (Al-Shaer and Zaman, 2016; Artiach, Lee, Nelson, & Walker, 2010; Hussain, Rigoni, & Orij, 2018; Kend, 2015; Kent & Monem, 2008), there were comparably few studies focused on developing countries (Amran & Haniffa, 2011; Kiliç & Kuzey, 2017; Kuzey & Uyar, 2017). Because developed and developing countries exhibit different characteristics with respect to growth rates as well as institutional and legal environments, it is inappropriate to attribute the findings of developed countries as being similar to developing ones. Therefore, this study contributes to the literature by enhancing our understanding of sustainability reporting aspects in a developing country, namely Turkey. Further, to the best knowledge of the authors, this is the first study examining the impact of board characteristics on GRI adoption amongst Turkish companies.

Second, prior literature had examined several corporate characteristics (i.e., firm size, profitability, leverage, industry affiliation, liquidity, free cash flow, etc.) on the willingness of companies to publish sustainability reports in compliance with the GRI framework (Fernandez-Feijoo, Romero, & Ruiz, 2014; Kiliç & Kuzey, 2017; Kuzey & Uyar, 2017; Legendre & Coderre, 2013). Differing from the prior studies,

this paper focuses specifically upon the association between corporate governance and GRI-based sustainability reporting.

Third, while prior research explored the impact of board gender diversity on the financial performance of companies (Adams & Ferreira, 2009; Carter, Simkins, & Simpson, 2003; Erhardt, Werbel, & Shrader, 2003; Kilic, 2015; Kılıç & Kuzey, 2016), there are few studies investigating the association between board gender diversity and non-financial reporting (Barako & Brown, 2008; Frias-Aceituno et al., 2013; Hussain et al., 2018; Kılıç and Kuzey, 2018b; Liao et al., 2015; Prado-Lorenzo & Garcia-Sanchez, 2010). The number of studies examining the influence of board nationality diversity on sustainability reporting practices is also very limited (Barako & Brown, 2008; Frias-Aceituno et al., 2013; Kılıç & Kuzey, 2018b). Hence, this study adds to the literature by exploring whether board gender and nationality diversity influence the decisions of companies to produce GRI-based sustainability reports. Moreover, the prior empirical findings on the relationship between board characteristics (i.e., board size, board independence, and board diversity) and non-financial reporting are inconclusive and contradictory (Hussain et al., 2018; Kent & Monem, 2008; Prado-Lorenzo & Garcia-Sanchez, 2010; Said, Zainuddin, & Haron, 2009). In a sense, this research provides further exploratory insights into these associations.

The remainder of this paper is structured as follows. The next section presents prior literature. The third section explains the theoretical framework and develops the hypotheses. The fourth section describes the research methodology. The fifth section presents the results. The sixth section discusses the findings in relation to the relevant literature. Finally, the last section concludes the paper.

Literature Review

As concerns about social and environmental issues grow, sustainability reporting receives increasing attention from researchers. Accordingly, a number of papers have been published examining the social and environmental reporting practices of companies (Ali, Frynas, & Mahmood, 2017; Dienes, Sassen, & Fischer, 2016). One strand of research has focused on the factors impacting the extent of social and environmental disclosures of companies (Alsaeed, 2006; Amran & Haniffa, 2011; Artiach et al., 2010; Hossain & Reaz, 2007; Hussain et al., 2018; Kansal, Joshi, & Batra, 2014; Kılıç & Kuzey, 2018b; Said, Zainuddin, & Haron, 2009; Uyar, Kilic, & Bayyurt, 2013). Another strand of research has particularly focused on the factors impacting company decisions to produce stand-alone sustainability reports (Fernandez-Feijoo et al., 2014; Kend, 2015; Kiliç & Kuzey, 2017; Kuzey & Uyar, 2017; Legendre & Coderre, 2013). For instance, Legendre and Coderre (2013) examined the relationship between company-specific characteristics (i.e., size, profitability, leverage, and industry affiliation) and GRI adoption among the Fortune Global 500 companies. In addition to these corporate characteristics, Kuzey and Uyar (2017) explored the influence of liquidity, free cash flow, growth opportunity, and ownership structure on GRI-based sustainability reporting in Turkey. Using an international sample,

Fernandez-Feijoo et al. (2014) analyzed how pressures of stakeholders affect the transparency of sustainability reporting of companies operating in different industries. Further, Kiliç and Kuzey (2017) investigated the impact of corporate governance characteristics (i.e., listing in the corporate governance index and the presence of a sustainability committee) and company-level variables (i.e., industry membership, firm size, profitability, and leverage) on publishing stand-alone sustainability reports in Turkey. With respect to the association between corporate governance and sustainability reporting, Amran, Lee, and Devi (2014) analyzed the impact of various board characteristics on the quality of sustainability reporting by companies domiciled in the Asia-Pacific region. In addition, Kent and Monem (2008) examined the impact of corporate governance on the adoption of triple bottom line (TBL) reporting by Australian companies. Using a sample from Australian and UK companies, Kend (2015) explored the impact of selected governance characteristics on the choice of companies to produce standalone sustainability reports. The above cited studies indicated a lack of research focusing on the association between corporate governance and standalone sustainability reporting. This motivated us to examine whether board structure impacts the publishing of sustainability reports complying with the GRI framework.

In prior literature, the influence of board gender diversity on corporate social responsibility (CSR) reporting (Barako & Brown, 2008; Hussain et al., 2018), environmental reporting (Ben-Amar et al., 2017; Hollindale, Kent, Routledge, & Chapple, 2017; Kılıç & Kuzey, 2018b; Liao et al., 2015; Prado-Lorenzo & Garcia-Sanchez, 2010), as well as adoption of integrated reporting (Frias-Aceituno et al., 2013) have been investigated. More particularly, Al-Shaer and Zaman (2016) explored the impact of board gender diversity on sustainability reporting quality. Further, few studies investigated the association between board nationality diversity and corporate reporting (Barako & Brown, 2008; Frias-Aceituno et al., 2013; Haniffa & Cooke, 2002; Kılıç & Kuzey, 2018b). In this respect, another motivation for this study was to test whether board gender and nationality diversity associated with decisions of companies to publish GRI-based sustainability reports. Overall, in this paper, we aim to examine the link between various board characteristics (i.e., board size, board independence, board diversity, and board committee) and GRI adoption by Turkish companies. Thus, we state the following research question:

Research question: Does board structure impact company decisions to publish GRI-based sustainability reports?

Theoretical Framework and Hypotheses

Theoretical Framework

Agency and stakeholder theories complement each other by suggesting the alignment of respective goals by management, stockholders, and stakeholders (Hussain

et al., 2018). Agency theory explains the conflicting relationship between managers and stakeholders, based upon assumption of information asymmetry, opportunistic behavior of agents, and conflicts of interest between principals (shareholders) and agents (managers) (Fama & Jensen, 1983). This theory links corporate governance to disclosure behavior by suggesting that effective corporate governance strengthens a company's internal control, and thereby prevents managers from withholding information for their own benefit (Ho & Wong, 2001).

According to stakeholder theory, stakeholders (i.e., investors, customers, government, employees, etc.) can affect or be affected by the actions of the firm (Freeman, 1984). An organization may therefore strive to harmonize its activities in accordance with stakeholder expectations in order to survive and thrive (Barako & Brown, 2008). In this sense, releasing high-quality sustainability reports may reflect a company's commitment to operate in a socially and environmentally responsible manner while at the same time considering the expectations and needs of various stakeholder groups (Kent & Monem, 2008; Kansal et al., 2014; Michelon & Parbonetti, 2012). Consequently, this study relies on mainly agency and stakeholder theories in order to understand the impact of board characteristics on the willingness of companies to publish GRI-based sustainability reports.

Hypotheses

Board Size

Agency theory argues that company boards are important mechanisms that create the ability to control and monitor managers (Fama & Jensen, 1983). According to John and Senbet (1998), board size may enhance the monitoring capacity and effectiveness of a board. Because larger boards have a greater number of directors who bring varied skills and expertise in accounting and finance, and sustainability etc., the board size may improve corporate reporting (Frias-Aceituno et al., 2013). Therefore, it could be argued that board size and corporate reporting are positively associated due to the enhanced monitoring capacity and resulting capability of boards.

However, empirical findings are mixed and inconsistent. While Frias-Aceituno et al. (2013) and Al-Shaer and Zaman (2016) documented a positive association between board size and sustainability reporting, Prado-Lorenzo and Garcia-Sanchez (2010) detected a negative association. Further, Amran et al. (2014), Hussain et al. (2018), Kent and Monem (2008), and Kılıç and Kuzey (2018b) were unable to find a significant association between board size and the extent of sustainability disclosures. Given the theoretical arguments, we expect that larger boards would promote the disclosure of a greater amount of corporate information. Thus, we offer the following hypothesis:

Hypothesis 1. Board size has a significant and positive association with publishing a GRI-based sustainability report.

Board Independence

Agency theory argues that with a higher number of independent directors on a board, it would more effectively control managerial opportunism (Fama & Jensen, 1983); hence companies with higher board independence are expected to disclose a greater degree of voluntary information (Haniffa & Cooke, 2002; Ho & Wong, 2001). Further, in the context of stakeholder theory, because independent directors are subject to less pressure from shareholders than internal members, they may have more willingness to encourage companies to disclose a wide range of voluntary information (Amran et al., 2014; Hussain et al., 2018; Michelon & Parbonetti, 2012). Therefore, independent directors would comprise a broader view of organizational performance incorporating social and environmental aspects, rather than focusing only on financial aspects (Liao et al., 2015). In this context, it could be argued that board independence would enhance the willingness of companies to publish stand-alone sustainability reports using the GRI framework.

Although theoretical discussions suggest a positive link between board independence and sustainability reporting, empirical findings are inconclusive. Barako and Brown (2008), Hussain et al. (2018), Liao et al. (2015), and Uyar et al. (2013) documented a significant positive association between board independence and the level of voluntary non-financial disclosures, whereas other studies found it to be insignificant (Amran et al., 2014; Al-Shaer & Zaman, 2016; Frias-Aceituno et al., 2013; Ho & Wong, 2001; Hossain & Reaz, 2007; Kent & Monem, 2008; Kılıç & Kuzey, 2018b; Prado-Lorenzo & Garcia-Sanchez, 2010; Said et al., 2009) or negative (Michelon & Parbonetti, 2012). Following the theoretical arguments, we assert the following hypothesis:

Hypothesis 2. Board independence has a significant and positive association with publishing a GRI-based sustainability report.

Board Diversity

Board diversity reflects the differences among board members with respect to their various characteristics, such as gender, nationality, age, tenure, education, etc. (Prado-Lorenzo & Garcia-Sanchez, 2010). On the one hand, it is argued that personal differences among board members may lead to conflict in the workplace, so that diverse boards might pose challenges to the organization of work (Estélyi & Nisar, 2016). On the other hand, proponents of diversity argue that since the marketplace is becoming more diverse, board diversity increases its ability to understand the needs and expectations of the marketplace (Carter et al., 2003). Further, diversity increases board independence and activism because people with a different gender, ethnicity, or cultural background would probably ask differing questions than board members with more traditional, similar backgrounds (Carter et al., 2003).

One of the most debated board diversity characteristics is gender (Barako & Brown, 2008; Carter et al., 2003; Huse & Solberg, 2006; Liao et al., 2015). Because women and men have different cultural and social backgrounds, board gender diversity may act as an effective mechanism of corporate governance structure (Liao et al., 2015). For instance, appointing female directors to corporate boards could foster a diversity of opinions and perspectives to board discussions (Barako & Brown, 2008). The integration of the different skills and knowledge of the male and female directors would enhance group decision-making (Erhardt et al., 2003). Further, because female directors in general were better prepared for board meetings than their male counterparts, they became less dependent upon reports and presentations made by management (Huse & Solberg, 2006). Accordingly, Adams and Ferreira (2009) documented that board gender diversity enhances board independence and effectiveness. In this sense, it is expected that companies with effective boards will make high quality decisions regarding corporate reporting, and as a result would release high quality sustainability reports. Further, the greater sensitivity of female board members to social, environmental and ethical issues leads to an increased likelihood that companies with gender diverse boards to publish high quality sustainability reports (Al-Shaer & Zaman, 2016; Hollindale et al., 2017).

Prior literature has mostly documented a positive link between board gender diversity and non-financial reporting. For instance, Barako and Brown (2008) determined that the presence of women directors in a board is associated with a stronger orientation toward corporate social reporting. Frias-Aceituno et al. (2013) also found that board gender diversity intensifies the level of integration of corporate information. Further, Ben-Amar et al. (2017) and Liao et al. (2015) detected a positive link between board gender diversity and the likelihood of voluntary corporate disclosures regarding climate change-related risks. In addition, Al-Shaer and Zaman (2016) found that board gender diversity is associated with sustainability reporting quality. A recent study by Hussain et al. (2018) suggested that board gender diversity enhances the social performance of a company. However, Amran et al. (2014) and Prado-Lorenzo and Garcia-Sanchez (2010) documented an insignificant association between board gender diversity and the propensity of companies to disclose a greater amount of sustainability information. Consequently, in line with the theoretical arguments and prior empirical findings, we state the following hypothesis:

Hypothesis 3a. Board gender diversity has a significant and positive association with publishing a GRI-based sustainability report.

Nationality is one of the most frequently considered differentiating traits of board members (Prado-Lorenzo & Garcia-Sanchez, 2010). Since director characteristics affect board activities and decisions, it is expected that directors with different national and cultural backgrounds would influence corporate behavior and reporting practices (Frias-Aceituno et al., 2013). It is generally accepted that foreign board members enhance the quality of board decisions because nationality is an important source of individual competence (Estélyi & Nisar, 2016). In developing countries, the CSR reporting practices of companies are influenced by external forces and powerful stakeholders, such as international buyers, foreign investors, and international

regulatory bodies (Ali et al., 2017). Therefore, the nationality of directors may be a significant factor in delivering the interests and expectations of these powerful stakeholders into corporate reporting practices.

In the prior literature, few studies explored the impact of board nationality diversity on the non-financial reporting practices of companies. For example, Barako and Brown (2008) were unable to find a significant association between the proportion of foreign directors and the level of voluntary disclosures. Frias-Aceituno et al. (2013) also failed to determine a significant link between the percentage of foreign board members and the level of integration of corporate information. However, Kılıç and Kuzey (2018b) determined a significant and positive association between the number of foreign directors on a board and carbon disclosures. Following the theoretical arguments, we suggest the following hypothesis:

Hypothesis 3b. Board nationality diversity has a significant and positive association with publishing a GRI-based sustainability report.

Board Committee

A board committee that is established specific to address social and environmental issues demonstrates the sustainability commitment of the organization to its stakeholders (Kent & Monem, 2008). Sustainability committees are instituted by companies to integrate sustainability matters into corporate operations and strategies (Ruhnke & Gabriel, 2013) and to ensure that social and environmental issues are incorporated into every aspect of business decision-making (Amran et al., 2014). Such a committee could be considered to be an effective monitoring device for improving the range and quality of information disclosed to stakeholders (Michelon & Parbonetti, 2012).

In support of the above arguments, Liao et al. (2015) detected that a board with an environmental committee exhibits a greater tendency to disclose greenhouse gas (GHG) information. In addition, Kend (2015), Kent and Monem (2008), and Kiliç and Kuzey (2017) determined that having a sustainability committee is a significant determinant of sustainability reporting. Moreover, Amran et al. (2014), Hussain et al. (2018), and Kılıç and Kuzey (2018a) found that the existence of a sustainability committee plays a significant role within the extent of company disclosures. In line with the above theoretical discussions and prior empirical findings, it is expected that companies with a sustainability committee are more likely to publish a separate GRI-based sustainability report. Thus, we state the following hypothesis:

Hypothesis 4. The existence of a sustainability committee has a significant and positive association with publishing a GRI-based sustainability report.

Research Methodology

Sample

The initial sample was comprised of the largest 100 companies, based upon market value, that were listed in the BIST over the period between 2013 and 2016, inclusive. This particular period was selected since most of the companies had published sustainability reports from 2013 and onwards. Holding, real estate, and sport companies were excluded from the initial sample due to their different financial reporting practices, leaving a sample of 77 firms and 308 firm-year observations. Subsequently, observations with unavailable data were also eliminated, leaving a total of 64 firms and 256 firm-year records for the analysis.

Data Reprocessing

Because reprocessing of the data is critical before performing the testing of the hypothetical relationships, data screening steps were initially undertaken. Univariate and multivariate outliers were determined, using a Z-score with greater than three and Mahalanobis D^2. Consequently, we observed that there were no extreme outliers or large portions of missing data.

Dependent Variable

In order to identify dependent, independent, and control variables, we followed prior studies on sustainability reporting (Barako & Brown, 2008; Frias-Aceituno et al., 2013; Ho & Taylor, 2007; Hussain et al., 2018; Kiliç & Kuzey, 2017; Kuzey & Uyar, 2017; Legendre & Coderre, 2013; Rossi & Tarquinio, 2017). The definitions of dependent, independent and control variables are shown in Table 1. Dependent variable, GRI-based sustainability reporting (GRI-SR) was identified as a dummy variable which equals one if a firm publishes a GRI-based sustainability report, and zero otherwise.

Independent Variables

Board size (BSIZE) was measured by the natural logarithm of the total number of board members. Further, board independence (BINDP) was identified as the proportion of outside members to the total number of directors on the board. Further,

Table 1 Variable definitions

	Operational definition
Dependent variables	
GRI-based sustainability reporting (GRI-SR)	1 if a firm publishes a GRI-based sustainability report, 0 otherwise
Independent variables	
Board size (BSIZE)	The natural logarithm of total number of board members
Board independence (BINDP)	The proportion of independent directors to total number of directors
Board gender diversity (BGENDER)	The proportion of female directors to total number of directors
BLAUGENDER	Blau index of gender diversity
Board nationality diversity (BFOREIGN)	The proportion of foreign directors to total number of directors
BLAUFOREIGN	Blau index of nationality diversity
Board committee (BCOMMITTEE)	1 if a firm has a board committee focusing on sustainability issues, 0 otherwise
Control variables	
Firm size (SIZE)	The natural logarithm of total assets
Return on equity (ROE)	The proportion of net income to total equity
Leverage (LEV)	The proportion of total liabilities to total assets

two proxies were used to measure the board gender diversity. First, the percentage of female directors on a board (BGENDER) was calculated. Second, following prior studies (Al-Shaer & Zaman, 2016; Ben-Amar et al., 2017; Kilic, 2015; Kılıç & Kuzey, 2016), Blau (1977) the index of heterogeneity (BLAUGENDER) was measured. The Blau index ranges between 0 when there is only one gender represented in the boardroom and 0.50 when there are equal numbers of female and male directors on the board (Ben-Amar et al., 2017). In a similar vein, board nationality diversity was identified with two proxies, including the percentage of foreign members to total members (BFOREIGN) and the Blau index of heterogeneity (BLAUFOREIGN). In addition, BCOMMITTEE was identified as a dummy variable which equals one if a board committee was established to focus on sustainability issues, zero otherwise.

Control Variables

In addition to board characteristics, we controlled the influence of some variables (i.e., firm size, profitability, and leverage) on the GRI-based sustainability reporting. Prior literature suggests a positive association between firm size and non-financial

reporting for several reasons. First, the cost of disseminating and preparing disclosures may be more affordable for larger companies compared to smaller companies (Ho & Taylor, 2007; Hossain & Reaz, 2007). Second, because larger companies have a greater number of stakeholders, they face more pressure to engage in responsible reporting practices (Artiach et al., 2010; Kansal et al., 2014; Legendre & Coderre, 2013). Further, the management of a larger company is not as inclined to believe that the full disclosure of information would jeopardize its competitive position as the management of a smaller company (Hossain & Reaz, 2007). Following these arguments, we expect a positive link between firm size and GRI-based sustainability reporting. The firm size (FSIZE) was calculated by the natural logarithm of total assets.

Theoretical discussions generally suggest a positive link between financial performance and sustainability reporting. When the financial performance of a company is high, the firm has a greater amount of resources to invest in sustainability activities (Artiach et al., 2010) and to produce sustainability reports (Ruhnke and Gabriel, 2013). On the contrary, stakeholder theory suggests that when financial performance is low, the company will be under pressure to reduce costs and enhance financial returns (Artiach et al., 2010). Thus, we expect that companies with higher profitability might have a higher propensity to exhibit a greater level of sustainability performance and to engage in sustainability reporting. Profitability was calculated using the return on equity (ROE) as the ratio of net income to total equity.

Creditors, as suppliers of capital to the firm, have concerns about the repayment of loans and interest (Kuzey & Uyar, 2017). A widely held view is that highly leveraged companies are expected to disclose comprehensive information in order to assure creditors regarding their ability to cover their obligations (Alsaeed, 2006; Ho & Taylor, 2007). Further, highly leveraged companies are prone to a higher agency cost, which may be reduced by voluntary information disclosures (Alsaeed, 2006; Hollindale et al., 2017). In line with these arguments, we expect that companies with a higher leverage are more likely to disclose a greater level of voluntary information. Leverage (LEV) was measured as the percentage of total liabilities to total assets.

Results

Descriptive Statistics

The summary statistics results regarding the sample of interest in this study are presented in Table 2. The results showed that 28.5% of the firms had GRI based sustainability reporting and 29.7% had a board committee specific to social and environmental matters. Moreover, the average board size was 8.71 ± 2.29, the average board independence was 0.31 ± 0.06, the average percentage of female directors was 0.12 ± 0.12, the average Blau index of gender diversity was 0.18 ± 0.16, the average percentage of foreign directors was 0.14 ± 0.20, and the average Blau index of

Table 2 Descriptive statistics

Variables	Min	Max	Mean	S.D.
BSIZE	5.00	15.00	8.71	2.29
BINDP	0.13	0.50	0.31	0.06
BGENDER	0.00	0.43	0.12	0.12
BLAUGENDER	0.00	0.49	0.18	0.16
BFOREIGN	0.00	0.83	0.14	0.20
BLAUFOREIGN	0.00	0.50	0.17	0.21
SIZE	7.71	11.49	9.60	0.87
ROE	−8.48	0.53	0.04	0.58
LEV	0.03	1.00	0.59	0.23
		Categories	**n**	**%**
GRI-SR		Non-exist	183	71.5
		Exist	73	28.5
		Total	*256*	*100*
BCOMMITTEE		Non-exist	180	70.3
		Exist	76	29.7
		Total	*256*	*100*

nationality diversity was 0.17 ± 0.21. The results also indicated that the mean firm size based on natural logarithm was 9.6 ± 0.87, the mean ROE was 0.04 ± 0.58, and the mean leverage was 0.59 ± 0.23.

Correlation Analysis

The correlation analysis results are shown in Table 3. The results indicated that BGENDER had a negative significant bivariate association with GRI-SR. In addition, BLAUFOREIGN, BSIZE, BCOMMITTEE, SIZE, and LEV had positive significant linear associations with GRI-SR. Moreover, BLAUGENDER, BFOREIGN, BINDP, and ROE had no significant linear association with GRI-SR at a 5% significant level. As shown in the correlation analysis, BLAUGENDER and BGENDER as well as BFOREIGN and BLAUFOREIGN had a high correlation, which might have resulted in high multicollinearity in the regression analysis. Therefore, these variables were included in the regression analysis separately in order to eliminate the multicollinearity and to obtain reliable results.

Table 3 Pearson's correlation analysis results

Variables	1	2	3	4	5	6	7	8	9	10	11
(1) GRI-SR	1										
(2) BLAUGENDER	−0.093	1									
(3) BGENDER	−.131*	.980**	1								
(4) BFOREIGN	0.096	−.316**	−.299**	1							
(5) BLAUFOREIGN	.129*	−.299**	−.280**	.934**	1						
(6) BSIZE	.533**	−.224**	−.253**	.278**	.327**	1					
(7) BINDP	−0.009	−.166**	−.153*	−.159*	−.162**	−.269**	1				
(8) BCOMMITTEE	.499**	−0.017	−0.05	.185**	.214**	.393**	−0.047	1			
(9) SIZE	.515**	−.244**	−.283**	.239**	.239**	.457**	.222**	.534**	1		
(10) ROE	0.054	−0.037	−0.027	0.017	0.028	0.103	−0.03	0.02	0.1	1	
(11) LEV	.344**	−.165**	−.160*	.306**	.305**	.290**	0.081	.396**	.494**	−.190**	1

$^{*}p < 0.05$, $^{**}p < 0.01$

Logistic Regression Analysis

To determine whether there was a high correlation among the independent variables, Variance Inflation Factor (VIF) values were calculated. The VIF values ranged between 1.11 and 2.18, which are far below than the recommended value of 10. Thus, it was determined that the proposed models did not pose any multicollinearity issue. The proposed models are listed below.

Model 1: GRI-SR = β_0 + β_1BGENDER + β_2BLAUFOREIGN + β_3BSIZE + β_4BINDP + β_5BCOMMITTEE + β_6SIZE + β_7ROE + β_8LEV + ε

Model 2: GRI-SR = β_0 + β_1BGENDER + β_2BFOREIGN + β_3BSIZE + β_4BINDP + β_5BCOMMITTEE + β_6SIZE + β_7ROE + β_8LEV + ε

Model 3: GRI-SR = β_0 + β_1 BLAUGENDER + β_2BLAUFOREIGN + β_3BSIZE + β_4BINDP + β_5BCOMMITTEE + β_6SIZE + β_7ROE + β_8LEV + ε

Model 4: GRI-SR = β_0 + β_1BLAUGENDER + β_2BFOREIGN + β_3BSIZE + β_4BINDP + β_5BCOMMITTEE + β_6SIZE + β_7ROE + β_8LEV + ε

Logistic regression analysis was utilized to test the proposed hypothesis since the dependent variable, GRI-SR, was a binary variable. Initially, the main independent variables were subjected to analysis first, after which the main independent variables with the control variables were subjected to analysis. The logistic regression analysis results are shown in Table 4. The results for Model 1 revealed that BLAUFOREIGN ($\beta = 2.24$, p-value < 0.05) had a significant negative relationship with GRI-SR while BSIZE ($\beta = 12.4$, p-value < 0.01), BCOMMITTEE ($\beta = 1.20$, p-value < 0.01), and SIZE ($\beta = 0.86$, p-value < 0.05) each had a significant positive impact on GRI-SR. In Model 2, there was a negative significant association between BFOREIGN and GRI-SR ($\beta = -3.16$, p-value < 0.05), and BSIZE ($\beta = 12.9$, p-value < 0.01), BCOMMITTEE ($\beta = 1.21$, p-value < 0.01), SIZE ($\beta = 0.87$, p-value < 0.05) had positive significant relationships with GRI-SR. However, BGENDER, BINDP, ROE, and LEV had no significant relationship with GRI-SR at a 5% significant level in both Model 1 and Model 2.

Based upon the results for Model 3, BLAUFOREIGN ($\beta = -2.17$, p-value < 0.10) had a negative significant impact on GRI-SR while BSIZE ($\beta = 12.6$, p-value < 0.01), BCOMMITTEE ($\beta = 1.18$, p-value < 0.01), and SIZE ($\beta = 0.85$, p-value < 0.05) had positive significant impact on GRI-SR. Finally, the results for Model 4 revealed that BFOREIGN ($\beta = -3.11$, p-value < 0.05) had a negative significant association with GRI-SR while BSIZE ($\beta = 13.1$, p-value < 0.01), BCOMMITTEE ($\beta = 1.19$, p-value < 0.01), and SIZE ($\beta = 0.86$, p-value < 0.05) had positive significant associations with GRI-SR. On the other hand, however, BLAUGENDER, BINDP, ROE, and LEV had no significant associations with GRI-SR at a 5% significant level in both Model 3 and Model 4.

Table 4 Logistic regression analysis results

	GRI-SR	GRI-SR	GRI-SR	GRI-SR	GRI-SR	GRI-SR	GRI-SR	GRI-SR
Independent variables					Mode l	Model 2	Model 3	Model 4
BLAUGENDER			0.66 (0.47)	0.60 (0.43)			1.30 (0.85)	1.31 (0.85)
BGENDER	0.22 (0.11)	0.14 (0.07)			1.25 (0.55)	1.26 (0.56)		
BFOREIGN		−2.32** (−2.02)		−2.25* (−1.94)		−3.16** (−2.36)		−3.11** (−2.30)
BLAUFOREIGN	−1.72* (−1.71)		−1.65 (−1.62)		−2.24** (−1.97)		−2.17* (−1.89)	
BSIZE	14.0*** (5.78)	14.3*** (5.77)	14.2*** (5.89)	14.5*** (5.89)	12.4*** (4.60)	12.9*** (4.57)	12.6*** (4.67)	13.1*** (4.65)
BINDP	4.37 (1.55)	4.13 (1.48)	4.63 (1.63)	4.39 (1.57)	0.61 (0.19)	−0.027 (−0.01)	0.83 (0.26)	0.18 (0.06)
BCOMMITTEE	1.90*** (5.05)	1.94*** (5.09)	1.89*** (5.01)	1.93*** (5.05)	1.20*** (2.80)	1.21*** (2.82)	1.18*** (2.76)	1.19*** (2.78)
SIZE					0.86** (2.48)	0.87** (2.46)	0.85** (2.45)	0.86** (2.43)
ROE					0.073 (0.11)	0.061 (0.09)	0.077 (0.11)	0.066 (0.10)
LEV					1.09 (0.95)	1.36 (1.15)	1.17 (1.01)	1.44 (1.21)
Constant	−16.1*** (−5.92)	−16.3*** (−5.91)	−16.5*** (−6.06)	−16.7*** (−6.04)	−22.4*** (−5.89)	−22.8*** (−5.86)	−22.7*** (−6.01)	−23.1*** (−5.98)
N	*256*	*256*	*256*	*256*	*256*	*256*	*256*	*256*
$\chi 2$	*115.6****	*116.9****	*115.8****	*117.1****	*127.6****	*129.6****	*128.1****	*130.1****

t statistics in parentheses; $^{*}p < 0.10$, $^{**}p < 0.05$, $^{***}p < 0.01$

Discussions

In line with the arguments of agency theory and the findings of Frias-Aceituno et al. (2013) and Al-Shaer and Zaman (2016), we provided evidence that large boards positively affect GRI-based sustainability reporting. Thus, Hypothesis 1 is accepted. This positive relationship could be explained by the following reasons. First, a greater number of directors enhance the monitoring capacity and effectiveness of boards (John and Senbet, 1998). Enhanced monitoring capacity of a board could lead to a higher level of accountability through transparent corporate reporting. Second, large boards have a greater number of directors with diversified expertise as compared to smaller boards, which improves the quality of decisions (Guest, 2009). In this context, large boards may promote high-quality sustainability reporting and encourage their companies to adopt the GRI framework. Further, because GRI reporting requires different types of expertise in different fields (i.e., accounting, finance, sustainability, etc.), inclusion of a greater number of directors to boards may have a positive influence on GRI adoption.

While agency and stakeholder theories suggest a positive link between board independence and sustainability reporting, we determined that there was no significant impact of board independence on GRI reporting. Thus, Hypothesis 2 is rejected, implying that independent directors do not appear to play a significant role in engaging in transparent corporate reporting practices. It is widely accepted that board independence enhances corporate disclosures because independent directors can be effective in controlling managerial opportunism (Ho & Wong, 2001) and they tend to show broader accountability to stakeholders (Liao et al., 2015). The lack of a significant link between board independence and GRI reporting may be attributed to the limited independence and effectiveness of independent directors as a monitoring device, because the majority is appointed by the board chairman or the CEO (Ho & Wong, 2001). In addition, the influence of independent directors in sustainability reporting would be restricted because they are not involved in daily business operations (Amran et al., 2014). Further, the impact of independent directors on board decisions will not be homogeneous because they exhibit different characteristics in terms of skills, expertise, and backgrounds (Michelon & Parbonetti, 2012). In this sense, the independence of a board should be measured through considering the different individual characteristics of directors beyond the traditional classifications as dependent and independent (Michelon & Parbonetti, 2012).

Contrary to prior assumptions, we failed to determine a significant association between board gender diversity and GRI reporting. Thus, Hypothesis 3a is rejected. This is in contrast to many prior findings documented by Al-Shaer and Zaman (2016), Barako and Brown (2008), Ben-Amar et al. (2017), Frias-Aceituno et al. (2013), Hussain et al. (2018), and Liao et al. (2015). A number of studies have underlined the need for reaching a *critical mass* of three female directors on boards in order to impact board decisions (Ben-Amar et al., 2017; Hollindale et al., 2017; Torchia, Calabrò, & Huse, 2011). In line with the *critical mass* hypothesis, the insignificant

link that was encountered between board gender diversity and GRI reporting might be attributed to the fact that there are few women directors on Turkish boards. Further, we were surprised to find that companies with national diverse boards are less likely to publish a sustainability report using the GRI framework. Thus, Hypothesis 3b is rejected.

Consistent with stakeholder theory, we determined that the presence of a board committee focusing on sustainability issues has a significant positive impact on the GRI adoption. Thus, Hypothesis 4 is accepted. This result confirms the findings of many prior studies (Amran et al., 2014; Hussain et al., 2018; Kend, 2015; Kent & Monem, 2008; Kiliç & Kuzey, 2017; Kılıç & Kuzey, 2018a; Liao et al., 2015), underlining the significant role of sustainability committees in orienting companies toward responsible business operations and transparent reporting practices.

With respect to control variables, we found that there was a strong positive impact of firm size on the GRI reporting. This positive link is understandable because large companies have extensive financial resources (Alsaeed, 2006), higher human capital (Kuzey & Uyar, 2017), better organization structure (Uyar et al., 2013), and developed information systems (Uyar et al., 2013) all of which improve the extent and quality of their disclosures. Further, since large companies receive more attention from society (Kansal et al., 2014) and are subject to high agency costs due to the greater information asymmetry between managers and shareholders (Ho & Taylor, 2007), they are more likely to disclose increased information through stand-alone corporate reports. However, our findings showed that profitability and leverage do not appear to be significant predictors of GRI-based sustainability reporting.

Conclusion

This paper explored whether board characteristics are associated with GRI-based sustainability reporting. Our research contributes to the literature through enhancing our understanding regarding the impact of board structure on sustainability reporting aspects in a developing country, namely Turkey. Further, it contributes to the growing body of literature by empirically investigating the relationship between board diversity and GRI reporting.

Our results indicated that board size and the existence of a board committee are significantly and positively associated with a decision to release a stand-alone sustainability report using the GRI framework. However, surprisingly, board nationality diversity was found to be negatively associated with GRI-based sustainability reporting. Further, board independence and board gender diversity were found to have an insignificant impact.

This research presents several implications. First, our results indicate that a low percentage of Turkish companies (28.5%) have adopted the GRI framework. This confirms that GRI reporting is an underutilized corporate communication channel

of sustainability in Turkey. Emerging countries experience problems such as concentrated ownership, high information asymmetry, and greater agency costs which hinder international capital flow to these markets (Uyar et al., 2013). In many emerging countries, a key strategy for achieving fast economic development is by way of attracting as much foreign capital and investment as possible. In this sense, GRI adoption could mitigate information asymmetry, and improve corporate transparency, thereby enhance foreign capital inflows.

In 2014, the European Union (EU) issued the Non-Financial Reporting Directive (2014/95/EU) which requires non-financial information disclosure by companies with more than 500 employees (Kılıç & Kuzey, 2018a). Incorporating social and environmental concerns into business operations, policies and strategies has become crucial for Turkey's EU accession process (Kılıç & Kuzey, 2018a). In this context, promotion of the GRI framework could create awareness for companies regarding social and environmental issues, providing presentation of sustainability initiatives in a comparable and standardized form.

Second, our findings suggest that the companies should appoint a certain number of members to boards through which to enhance the quality of board decisions with respect to sustainability reporting. In prior literature, a board size ranging between 8 and 10 was suggested as ideal by Cadbury (1992) and Lipton and Lorsch (1992). Our findings also suggested that companies should institute a separate committee specifically to address social and environmental issues in order to provide transparent sustainability reporting. The role of a sustainability committee with respect to sustainability reporting is similar to the role of an audit committee in ensuring proper financial reporting (Liao et al., 2015).

Further, the lack of significance link between board gender diversity and sustainability reporting should be interpreted considering *critical mass theory*. Within the perspective of this theory, when there is only one female director in an otherwise male-dominated board, she may be considered as *token* and has a limited impact on corporate reporting practices (Amran et al., 2014; Ben-Amar et al., 2017). Although a comply-or-explain approach has been adopted to promote female representation on boards in Turkey, the number of female directors on boards remains low (Kilic, 2015; Kılıç and Kuzey, 2016). In this regard, a mandatory quota may need to be adopted in Turkey, as it has been adopted by Norway and Spain.

While this study contributes to the literature in several ways, it is not without limitations. First, it examines GRI reporting focusing on only one country which limits its generalizability. Further, it considers only two aspects of board diversity, being gender and nationality. Future research could consider other aspects of board diversity, such as expertise, education, age, culture etc.

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Merve Kılıç is an Independent Researcher in the field of accounting. Her research interests are corporate social reporting, sustainability reporting, integrated reporting, and corporate governance. Her studies have been published in several journals.

Cemil Kuzey is an Associate Professor at the Department of Computer Science at Murray State University, USA, teaching operation research and statistics for social sciences. His research interests are operation research, data mining, and business intelligence.

The Practices of Corporate Governance and Shariah Governance in Islamic Financial Institutions

Daing Maruak Sadek, Zakaria Abas, Khilmy Abd Rahim, Azyyati Anuar and Mas Aida Abd Rahim

The Corporate Governance System in Islamic Financial Institutions

Prior studies have shown corporate governance in the banking industry has been discussed primarily in the conventional perspective. There are two main models—Anglo-Saxon model which emphasizes on shareholder value and the stakeholder-centric European model—and their differences have been the subject of constant debate for years. However, not much has been written about the Islamic banking perspective despite the rapid growth of the industry since 1970, and the mark it is continuing to make in financial markets globally (Yunis, 2007).

More individuals, organizations and institutions started carrying out studies to address corporate governance issues, propelled by the failures of a number of IFIs in the 1990s and 2000s, such as the falls of Turkey's *Ihlas* Finance House, the Islamic Bank of South Africa and Islamic Investment Companies of Egypt. One such study that stood out was by Chapra and Ahmed (2002), who focused their research on the roles of Shariah boards, as well as the auditing, accounting and frameworks of corporate governance in IFIs. Others include Al-Baluchi (2006) on IFIs' corporate disclosure methods, and Al-Sadah (2007), who studied corporate governance of Islamic banks, its components, the effect it has on stakeholders and the role that supervisors of Islamic banks play. Meanwhile, IFSB released a survey on Shariah Boards of Institutions Offering Islamic Financial Services across Jurisdictions in 2008 (IFSB, 2008), as well as Faizullah (2009) who talked about Islamic banks and its governance, as well as the transparency and standardization of the framework.

D. M. Sadek (✉) · A. Anuar · M. A. Abd Rahim
Universiti Teknologi MARA (UiTM) Kedah, Merbok, Malaysia
e-mail: daing729@uitm.edu.my

Z. Abas · K. Abd Rahim
Universiti Utara Malaysia, Changlun, Malaysia

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As numerous as the researches have been, there is still not much literature available that thoroughly studies corporate governance and its theoretical foundation from the views of Islam. Choudury and Hoque (2004) did change it by deconstructing the framework of corporate governance from an Islamic perspective, which has shown that the theory is based on *Tawhīd* or the Oneness of God. Similarly, Iqbal and Mirakhor (2007) also did the same and recommended via their research the stakeholder value system, with a basis on the foundation of property rights and contractual obligation. Additionally, Safieddine (2009) also added to the existing studies by calling attention to the varieties in agency theory in Islamic banks amidst of all its uniqueness and complexity. Even today, corporate governance is seen to be a great concern to IFIs, supervisors, regulators and standards' body internationally.

Due to its role in promotion ideas of fairness, transparency and accountability, it cannot be denied that corporate governance is one of the most important aspects in IFIs. As a matter of fact, the challenge is greater compared to conventional finance system due to the additional risks it poses. As such, it is highly recommended for Islamic banks and financial institutions to apply a governance system and strategies that are effective as to encourage the adoption of Islamic corporate governance. In the light of this, this section will provide an overview of its foundational dimension, paying focus on the governance frameworks of IFIs. At the same time, it will attempt to shed light on the basics of Islamic corporate governance and to discuss any possible issues that can assist in clearing up the distinction between it and its conventional counterpart. The initial study is of the opinion that there are specific values and characteristics that Islam gives in corporate governance, with the purpose of upholding and maintaining social justice to both shareholders and stakeholders.

It must be noted that there is not much difference between the definition of Islamic corporate governance to the conventional definition, as ultimately both are systems where organizations are managed, directed and controlled as to achieve the objectives and goals set by the said corporation, while protecting the interests of the stakeholders. What makes the Islamic perspective distinctive to conventional ones is some of its characteristics and features which are unique in comparison.

Choudhury and Hoque (2006) said that theoretical structure of corporate governance in Islam is basically a decision-making process based on the *Tawhīd* epistemology. They also made a point to note its practical implications, particularly when it comes to transaction cost minimization in environments where the decision-making process takes place and when striving to achieve an organization's objectives within the confines of Shariah permissibility (Choudhury & Hoque, 2006). As such, it is imperative to understand the Islamic point of view of governance as to ensure that any discussion of it is done with clarity.

Role of Corporate Governance in IFIs

A need for an efficient and effective governance system is very important in corporate governance, especially after the high-profile falls of many IFIs (such as *Ihlas* Finance

House in Turkey, the Islamic Bank of South Africa and the Islamic Investment Companies of Egypt) and the difficulties that some of the others face (Dubai Islamic Bank and Bank Islam Malaysia Berhad, to name a few). Islamic institutions are no less vulnerable to crises and issues that arise from governance-related problems like other organizations.

There is not much difference between the roles of corporate governance in IFIs to other types of organizations, with promoting corporate fairness, transparency and accountability as the main objectives. It is vital to have a good corporate governance to ensure that the rights and interests of stakeholders are protected fully. As such, this has been known to be the reason for the increasing attention the subject is getting, especially in firms in the finance industry (Macey & O'Hara, 2003). Thus, in the case of IFIs, the relationships that need to be maintained are not only the ones between stakeholders, shareholders and BOD, but with God, as well. This is why Shariah elements must be included in its frameworks, to accommodate to all of these needs and relationships equally.

It has been noted by Grais and Pallegrini (2006) that there are two corporate governance roles that are only for IFIs: to assure stakeholders of their organization's activities are in compliance to Shariah and that they are committed to ensuring that they will improve their growth as well as their efficiency, stability and dependability or trustworthiness. Hence, corporate governance reconciles these two roles as to make sure that they do not steer away from the original purpose of an organization, which is to maximize profits and at the same time safeguarding the stakeholders' interests.

Governance risk is one among many issues that implementation of corporate governance in IFIs can address. According to Iqbal and Mirakhor (2007), corporate risk is "the risk arising from failure to govern the institution, negligence in conducting business and meeting contractual obligations and from a weak internal and external environment", which is then further classified into different subcategories, namely operational, fiduciary, transparency, Shariah and reputation risks. Risks in IFIs are unique and have complexities that are unlike conventional financial institutions, and thus, a specialized and efficient system is needed to alleviate them.

As part of achieving this, IFIs must refrain from getting involved in any businesses or transactions that deal with *riba* (interest), *gharar* (uncertainty), speculation and *maysir* (gambling) and also staying away from investing in any illegal activities, as well as observing and respecting the Islamic morality or ethical codes. IFIs have the responsibility to assure their stakeholders and the public that their products and services as well as their operations are free from anything that is not permissible and adhere to Shariah.

The Development of Corporate Governance in IFIs

For this section, we will go into understanding more about the development progress of corporate governance in IFIs, from its beginning until where it is today. It is categorized into two separate phases: pre-twentieth century and post-twentieth century. The second phase is broken down further into two, which are the first stage (pre-1970s) and the second stage (post-1970s).

Phase I (Pre-twentieth Century): The Absence of Corporate Governance in Traditional IFIs

The early ages of Islam did not recognize the term "bank"; the term *bayt al-māl*, however, was used in a large scale. Financiers were known as *ṣarrāf* and *jahbadh* during the pre-modern Islam era (eighth and ninth centuries), with functions similar to modern bankers. Among the roles of the *ṣarrāf,* institution was to provide financing facilities that were mostly based on the *mudhāraba*h and *mushārakah* contract systems, as well as promissory note and letter of credit issuances (Chapra & Ahmed, 2002). *Ṣarrāf* also catered to the banking needs of the community whether the public or the private sector, whereas *jahbadh* mainly accommodated the public. As for ownerships*, ṣarrāf* was held by individuals, families or tribes, while the state-owned *jahbadh*. However, these institutions were not banks for the lack of deposits or cheques they received or imposed. With this in mind, Udovitch (1970) has referred *to ṣarrāf* as bankers without a bank, rather than bank as financial intermediary (Chapra, 2007).

As the institutions of *ṣarrāf* or *jahbadh* were not considered as legal entities, there were no issues of corporate governance. However, they were able to perform their economic activities efficiently, both on domestic and international levels. There are no data available to confirm this, but the historical evidence that is available in many literatures is proof enough and strongly indicated the fact.

Phase II (Post-twentieth Century): The Emergence of Corporate Governance in Modern IFIs

Stage I: Pre-1970s

The emergence of non-Muslim *ṣarrāf* families and modern banks at the end of the nineteenth century mainly by Europeans as well as Armenian and Greek *ṣarrāf* had greatly reduced the Muslim role in the institution (Saeed, 2002). The situation was deepened by the colonization of Muslim countries, and eventually, the institution was replaced by the interest-based financial system of Western modern banking. This

remained until the 1950s, when active efforts to establish IFIs were taken. Pakistan, for example, took this step by adding a clause in their constitution to disallow interests and the creation of a local Islamic bank that catered mostly to the poor spurred this further as well. Later on in Egypt, Mitr Ghams Savings Bank was established on 23 July 1963, and a few years later in 1972, Nasser Social Bank emerged (Haron, 1997). The existence of these two banks during that time had proven the kind of potential and possibilities available for Islamic financial system in a modern economic world.

Although only considered a partial breakthrough, the successes of the pioneering Islamic banks specifically their operations, procedures, activities, performances, nature of financing facilities and socio-legal matters were discussed in-depth by numerous scholars. However, there were yet to be emphasized on corporate governance in any of these discussions and no initiatives in this regard were ever taken at this juncture. The reason for this is the fact that these banks were created as cooperative societies or social banks. As an addition, they had very limited financing activities modes and mainly took to remedy the needs of social and small communities. As such, to these types of firms, corporate governance is not seen to be a necessity.

Stage II: Post-1970s

In the Islamic financial industry, the years between 1975 and 1990 were considered to be very crucial, and the incorporation of many Islamic banks—such as Dubai Islamic Bank, Faisal Islamic Bank, Kuwait Finance House and Islamic Development Bank in Jeddah—was the push that the sector needed for a call for corporate governance system. Later on, during the times when the industry was facing difficulties between 1990s and 2000s, a few international institutions were set up to assist in enhancing their corporate governance frameworks, such as AAOIFI, Malaysia-based IFSB, International Islamic Financial Market (IIFM), Bahrain-based International Islamic Rating Agency (IIRA) and the General Council of Islamic Banks and Financial Institutions (CIBAFI). One of the reasons for the establishments of AAOIFI and IFSB was to address corporate governance issues in IFI, by issuing standards and guidelines to ensure the banks' best practice. Meanwhile, the other institutions named provide framework support for banks who wish to implement the Islamic finance system. Hawkamah Institute for Corporate Governance also took its own initiative by setting up a task force and working committee on IFIs' corporate governance issues, to study and come up with the best practice for corporate governance within the Middle East and North Africa region.

So far, AAOIFI has issued seven corporate governance standards. They are:

(I) Shariah Supervisory Board: Appointment, Composition and Report;
(II) Shariah Review;
(III) Internal Shariah Review;
(IV) Audit and Governance Committee for Islamic Financial Institutions;
(V) Independence of Shariah Supervisory Board;
(VI) Statement on Governance Principles for Islamic Financial Institutions; and

(VII) Corporate Social Responsibility Conduct and Disclosure for Islamic Financial Institutions.

IFSB has also issued eight guidelines focusing on governance, disclosure and supervisory review processes, namely:

(I) Guiding principles on governance for Islamic collective investment schemes;
(II) Guidance Note in Connection with the Capital Adequacy Standard: Recognition of Ratings by External Credit Assessment Institutions (ECAIs) on Shariah-Compliant Financial Instruments;
(III) Guidance on Key Elements in the Supervisory Review Process of Institutions offering Islamic Financial Services (excluding Islamic Insurance (Takāful) Institutions and Islamic Mutual Funds);
(IV) Disclosures to Promote Transparency and Market Discipline for Institutions offering Islamic Financial Services (excluding Islamic Insurance (Takāful) Institutions and Islamic Mutual Funds);
(V) Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services (Excluding Islamic Insurance (Takāful) Institutions and Islamic Mutual Funds);
(VI) Guiding Principles on Conduct of Business for Institutions offering Islamic Financial Services;
(VII) Guiding Principles on Governance for Takāful Operations; and Guiding Principles on Shariah Governance System for Institutions offering Islamic Financial Services.

Corporate Governance Framework in IFIs

This section shall concisely explain the Islamic perspective of corporate governance framework for IFIs by defining the roles, functions and relationships of the institutions' BOD, management, shareholders, depositors, and most importantly as the focus of the study, the Shariah board. For discourse purposes, the study will refer to IFSB-375 and will also refer to OECD's Principles of Corporate Governance and also the BCBS guideline. Both are considered to be relevant reads in examining the important elements of corporate governance's best practice, including but not limited to separation of ownership and control, transparency and market discipline, balancing the stakeholders' interest and information asymmetries.

One Islamic corporate governance framework is as explained by Abd Rahim (1998: 55–70). He noted that the framework combines Islamic and Shariah moral edicts and especially highlights *shura*, *ḥisbah* and religious audit as vital elements of the framework. To further break it down, the institution of *shura* consists of the BOD, management, shareholders, employees, customers and other relevant parties and may guarantee the effectiveness of any decision-making that can affect the organization. *Ḥisbah* and religious auditors, on the other hand, monitor the activities of

the corporations both regulatory and morally. Shariah board focuses on legal ruling issuances and as a provider for advisory and supervisory services in matters pertaining to Islamic law.

Choudury and Hoque (2004) illustrated a much more comprehensive Islamic corporate governance framework, which discusses the governance structure and the appropriate level of each institution, its roles and functions, aims and objectives, and governing laws of the corporation by using *Tawhīd* and *shura* epistemology as a basis. Another is by Nienhaus (2007), who addressed the aspects of Shariah regulatory framework, and banking law and regulations in general. Another important commentary is by Banaga, Ray and Tomkins, (1994), who incorporates a corporate culture and control mechanism in an Islamic setting together as an integrated framework.

All these illustrations by Abd Rahim (1998), Banaga et al. (1994), Choudury and Hoque (2004) and Nienhaus (2007) concluded that a conceptual framework of Islamic corporate governance must have the combination of these factors, such as *Tawhīd* epistemology, the process of *shura*, the concept of vicegerency (*khilafah*), social justice (*al-adl wal ihsān*), accountability (*taklīf*), Shariah regulations, general banking law and Islamic morality and its principles. Despite the conceptual framework, challenges do arise in addressing the operational issues of such a large-scale framework, to do the actual integrating, and internalize Islamic norms into the organizations. Banaga et al. (1994) specified, however, that enforcing Shariah, moral and ethical standards in a company does not automatically ensure an economic performance that is favourable.

There are additional elements that IFIs need as opposed to conventional banking institutions that are imperative in the integration of each component of Islamic corporate governance framework and make it work as seamlessly as possible. With this in mind, the IFSB-3's aim is to equip IFIs with guidelines and key principles to assist them in regard to the suitable governance structures and processes for them by using the stakeholder-oriented model as its foundation (IFSB, 2006).

We need to study the roles and responsibilities of the important participants of IFIs to help us better understand their corporate governance frameworks, such as shareholders, depositors, BOD, management and the Shariah board. In IFIs, the Shariah board, religious auditors and depositors especially investment account holders (IAHs) play vital roles for corporate governance in these institutions. In Table 1, these participants and their functions are examined.

The Shariah Governance System in Islamic Financial Institutions

For the purpose of Shariah compliancy, Islamic corporate governance needs to include an additional layer of governance in its philosophical foundation. In the light of this, IFIs need to apply the relevant institutional arrangements not only to

Table 1 Key participants in corporate governance in IFIs

Key participants	Interest	Functional roles
Regulatory authority	Economic stability	Set regulatory framework for sound corporate governance
Supervisory authority	Compliance with law and regulation	To oversee and monitor the effectiveness of corporate governance and ensure regulatory compliance
Shareholders	Wealth maximization, satisfactory earning per share, dividends, above average return on investment and excellent continuous growth	Appoint BOD, management auditors and Shariah board
IAHs	Repayment of deposits at maturity on the agreed terms; protection of their interests and profit	To monitor performance of their investment
Shariah board	Shariah compliancy; fulfilling *Maqāsid Shariah*	To make sure of Shariah compliance and protect the rights and interests of depositors and other stakeholders
BOD	Monetary and non-monetary compensation, high integrity, efficiency and effectiveness in company management and outstanding corporate reputation and brand	To set the direction and policies of the IFI
Management	Monetary and non-monetary compensation and commitment to claim of the contracts	To implement the policies set by the BOD

monitor their company's Shariah adherence, but to their operations as well. Due to the lack of Islamic literature when it comes to Islamic corporate governance, IFIs have taken matters into their hand by introducing into their corporate governance structure the Shariah governance system, making it unique compared to any conventional methods.

An efficient and effective Islamic governance system is of the essence when it comes to corporate governance for IFIs, especially given what had transpired with the financial scandals and failure of several Islamic financial firms, and the possibility of what can happen when Shariah is not complied. Shariah boards are one of the most important participants of Islamic corporate governance in IFIs and play a crucial role in supervising, monitoring, auditing and issuing legal decrees that pertain to the Islamic law. Shariah boards are also a central part of the Islamic governance model and are very influential to an Islamic institution's day-to-day operation with their advisory and consultative services.

There are strong calls for the need to have a sound and proper Islamic corporate governance system that is synergistic with the mammoth growth that the Islamic finance sector is experiencing worldwide, as well as the increasingly innovative and complex Islamic financial products and services offered in this day and age. This section aims to provide an overview to Shariah governance system and as such will be divided into ten sections, namely the introduction, conceptual framework, historical development, objective of Shariah governance system, roles of Shariah board, models of Shariah board, international standard-setting agency, Shariah governance process, issues and challenges, and conclusion.

Conceptual Framework of Shariah Governance Systems in IFIs

There was a lack of proper definition for the term "Shariah governance system", even from AAOIFI's Governance Standard No. 1–5, who made no mention of the actual definition, until IFSB published the Guiding Principles on Shariah Governance Systems in Institutions Offering Islamic Financial Services (IFSB-10). Even then, the definition pertained to corporate governance and not specifically Shariah governance. Additionally, both AAOIFI and IFSB do not explain or define the current governance standards. This lack of proper definition has led to uncertainty, as well as varying understanding and meaning to Shariah governance system. For this purpose, there needs to be some clarifications on the term and for it to have a clear and understandable meaning and concept.

IFSB-10 may have the most accurate Shariah governance definition, which is "a set of institutional and organizational arrangements through which IFIs ensure that there is effective independent oversight of Shariah compliance over the issuance of relevant Shariah pronouncements, dissemination of information and an internal Shariah compliance review" (IFSB, 2009). To clear it up, it can be divided into three elements:

1. Institutional and organizational arrangements: this first part relates to the Shariah board and any related institutions, for example the organization's internal audit department, or Shariah unit.
2. Effective independent oversight of Shariah compliance: this pertains to the goals and objectives of Shariah governance system, which is to provide the necessary and efficient instruments of Shariah compliancy purposes.
3. Shariah pronouncements, dissemination of information and an internal Shariah compliance review: this is indicative to Shariah governance processes, which is inclusive of the ex-ante as well as ex-post facets of Islamic law compliance structure.

The definition above suggests that a Shariah board is extremely important to the Shariah governance system, because as an authoritative body, it ensures adherence to Shariah in any IFIs. Shariah board is defined by AAOIFIs Governance Standard

No. 1 as “an independent body entrusted with the duty of directing, reviewing and supervising the activities of IFIs for the purpose of Shariah compliance and issuing legal rulings pertaining to Islamic banking and finance” (AAOIFI, 2005: 4), similar to the ones issued by IFSB-10, that is “a body comprised of a panel of Shariah scholars who provide Shariah expertise and act as special advisers to the institutions” (IFSB, 2009: 1). To be certain that a Shariah board is able to perform its job diligently, it needs to have a clear structure that will be vital in making sure its effectiveness, especially in regard to its independence, binding force of its edicts, objectivity and complete authority. Based on this, it can be ascertained that any arrangements made pertaining to how the board is directed, managed, governed and controlled—whether formally or informally—for Shariah compliancy reasons, are definitely part of the Shariah governance structure.

Shariah governance in a financial setting has a unique quality as it very much about the religious aspects of IFIs’ activities. Table 2 gives a clearer picture of Shariah governance system principles and how it is complementary to the existing framework of corporate governance in IFIs.

In Table 2, it is shown that typical financial institutions and Islamic financial institutions share similar institutional arrangements when it comes to corporate governance framework, most notably within the area of governance, control and compliance. In fact, the only difference between the two is that IFIs require a Shariah governance mechanism in their institutional arrangement, which includes a Shariah board, an internal or external Shariah review units, as well as an internal Shariah compliance unit to ensure that Islamic law compliancy in regard to all of their transactions and operations are met.

The Shariah governance system also adds another element to the current corporate governance framework. Table 2 is demonstrative of that, where it is shown that a Shariah board and internal or external Shariah review units are added to supervise the aspect of Shariah compliancy. This is based on AAOIFI’s governance standards and places the Islamic law board on the same level of importance as the BOD in the corporate governance framework and, as such, subject directly to the shareholders of the organization. However, in IFSB-10, it is noted that a Shariah board either operates parallel to the BOD or is actual a subordinate to the BOD. Despite these differing opinions, both organizations agree on the independence of Shariah board from the BOD and should be held accountable for both stakeholders and shareholders.

Table 2 Institutional arrangement in the Shariah governance system

Functions	Typical financial institutions	Exclusive to IFIs
Governance	BOD	Shariah board
Control	Internal and external auditors	Internal and external Shariah review units
Compliance	Regulatory and financial compliance officers, unit, and/or department	Internal Shariah compliance unit

Source IFSB (2009: 4)

Table 3 Corporate governance structure in IFIs

<table>
<tr><td rowspan="6">Guideline on governance

Code of conduct

Infrastructure

Due diligence

Communication
Internal control
Monitoring

Enforcement</td><td>Regulation</td><td rowspan="3"></td><td>Regulator</td><td rowspan="3"></td><td rowspan="5">Sharia' board</td></tr>
<tr><td>Electing BOD/approving key policies</td><td>Shareholder</td></tr>
<tr><td>Investor/shareholder protection</td><td>BOD</td></tr>
<tr><td>Board oversight</td><td>Risk committee</td><td>Audit committee</td><td>Governance committee</td></tr>
<tr><td colspan="4"></td></tr>
<tr><td>Management oversight</td><td>Risk management</td><td>Internal audit</td><td>Compliance officer</td><td>Internal Sharia' compliance unit/ department</td></tr>
</table>

Source: Stanley (2008): modified

Shariah governance structure has scopes that cover both ex-ante and ex-post aspects of Islamic law compliance; ex-ante is in reference to the issuance of Shariah edicts and the distribution of Shariah-related information, whereas ex-post refers to the periodic and annual Shariah review process that is done internally. Table 3 discusses these scopes. It must be mentioned that the illustrated process is only of the typical method to get approval for Islamic financial products and services in IFIs and that this process may differ from institution to institution. The table aims to give a clearer albeit general picture of Shariah governance, as well as its framework in any IFIs.

The scope of Shariah governance framework in IFIs, as demonstrated in Fig. 1, involves a specific process and calls for the involvement of many sections of governance. Processes 1 until 6—or Phase I—illustrate the ex-ante Shariah compliance elements, such as product proposal, legal documentation, Shariah review, as well as obtaining and the dissemination of Shariah rulings. Phase II, which is both processes 7 and 8, explains the ex-post mechanism, involving the periodic and yearly Shariah review. The Shariah board's role to ensure that the products and services the IFI offer adhere to Islamic law can only be achieved by having a reliable Shariah coordination and a Shariah review unit that is efficient and trustworthy. The person responsible for the Shariah coordination acts as a liaison to the whole governance process of the institution, from the first process in Phase I to Phase II's process 8.

The aim of this part is to explain the three elements of the conceptual framework of involved in Shariah governance of IFIs; the definition, the institutional arrangement and the capacity of the governance structure. To summarize, the Shariah governance system is about the relevant institutional arrangements that is required to achieve Shariah compliancy, involving both ex-ante and ex-post processes such as

Fig. 1 Scope of the Shariah governance framework. *Source* Dar (2009a, 2009b): modified

pronouncements, distribution of information and Shariah compliance review that is held internally. In the mentioned set of institutional arrangements, the Shariah board is seen as the most important element that guides the system or as the backbone. With this regard, this research studies the various Shariah governance practices that can be found in IFIs that has made their Shariah boards as focus points. At the same time, this study will also touch on their differences in governance framework and jurisdiction processes, such as the issues and challenges they face, with the aim of finding and promoting the best Shariah governance practice.

Objectives of the Shariah Governance System

The purpose of having Shariah governance system is simply within the reason of its existence, which is for Shariah compliance as per within the fundamentals of the religion. There are a number of steps and measures that need to be taken, involving

several different organs of governance, and it incurs monetary costs. Despite the amount of time, effort, and money establishing a Shariah governance structure may take, IFIs are favourable to having governance, or at least setting up Shariah boards within their organizations. However with this, a question now has arisen: to what degree does the significance of Shariah governance system for Islamic financial firms go? To understand this, we must explore the objectives and primary functions of Shariah governance in these institutions, such as to provide product legitimacy, the call for moderation and fairness in financial transactions, stakeholders' trust and as part of IFIs' risk management tools.

Islamic financial products must adhere to Shariah principles and are legitimate. As such, a specialized unit who are made up of individuals very well-versed in Islamic law is needed in IFIs, especially those with knowledge pertaining to *fiqh al muāmalāt* and *usul al fiqh*. These groups of individuals are important as to help ensure the legitimacy of the Islamic financial instrument. There are a number of issues that need to be addressed here so that the credibility of the Shariah board is not jeopardized, such as the independence, qualifications, reporting structure, accountability and transparency of the board, which subsequently helps in asserting whether a product is legitimate or not.

According to Wilson (2009: 61), having a sound Shariah governance framework is also an imperative part of the exercise to promote moderation and justice in any financial transactions and at the same time ensuring the public that the said IFI is Shariah compliant in all aspects. The objective of IFIs is to appease shareholders and at the same time gain the trust and assure the public and community who use their products. Without any governance system, the public may not be confident about the legality of the products. A proper Shariah governance system with both ex-ante and ex-post compliance processes would be more than helpful to highlight the IFI's credibility.

With the implementation of a Shariah governance framework, IFIs can also address the issues of Shariah non-compliance risks, which is defined by IFSB-3 as "the risk that arises from IFIs' failure to comply with the Shariah rules and principles determined by the Shariah board or the relevant body in the jurisdiction in which the IFIs operate" (IFSB, 2006: 26). At the same time, Delorenzo (2007: 398–407) also made references to Shariah non-compliance risk by inferring it to the possibility of fatwa rejection and that it can be a type of operational and regulatory risk. Iqbal and Mirakhor (2007: 245), on the other hand, differentiate Shariah risks into two groups; risk that comes to light due to practices of Islamic financial products that are not standard or regular and risk due to Shariah non-compliance.

Non-compliance risk in the Islamic finance sector is a serious issue, which is apparent in several cases, one being falling issuances of *sukuk* after the statement made by Chairman of the Shariah board at AAOIFI, Sheikh Muhammad Taqi Usmani, who said that 85% of *sukuk* in the Gulf are not Shariah compliant. There are other factors that could have affected *sukuk* issuance, but the claim he had made caused a loss of confidence by the public on the legitimacy of Islamic bonds. Another known case is the statement by the OIC Fiqh Academy that *tawarruq* is impermissible, which could lead to serious implications for IFIs as *tawarruq* is easily available

in the market. A third example is the issue of *Bai' Bithaman Ajil* (BBA) and the judgment by the Malaysian High Court, who had declared profit gained from the facility is not legitimate. This was a serious concern, as more than 80% financing instruments in Malaysia are designed based on BBA. Another similar case is the dispute between The Investment Dar Company KSCC v Blom Developments Bank Sal (2009) EWHC 3545 (Ch).

With these cases, it is apparent that Shariah governance system is a necessary tool that can assist in the mitigation of Shariah non-compliant risk. Shariah risk is not easily managed, unlike risks such as credit, equity investment, market, liquidity, and rate of return risks, which are all quantifiable. Additionally, there is not any specialized risk management model to cater to the non-compliance risk that specifically affects IFIs. As mentioned in IFSB's Guiding Principles on Risk Management (IFSB-1), Shariah risk is part of the operational risk, which a proper Shariah governance framework can address. The Islamic governance system can definitely assist IFIs oversee the Shariah governance risk, as it can cause unsurmountable lost and weaken the credibility of these Islamic organizations.

Conclusion

The purpose of this chapter is to explain a discourse on the basics of corporate governance system and Shariah governance system in Islamic Financial Institutions (IFIs). It is necessary as to familiarize ourselves with the Shariah governance concept within IFIs. In short, Islamic corporate governance is designed in such a way that it is unique, with a set of characteristics that makes it distinctive.

As for the nature of management, the Islamic governance model has a foundation in the concept of *shura*, in which the Shariah board supervises and oversees all corporate activities to ensure that the organization complies with the requirements of Shariah. Another difference it has with the Western models is that shareholders and IAHs are recognized as the owners along with the shareholders. To ensure that the organization's objectives are balanced with their duty towards the society, Islamic corporate governance are also driven by the combination of *Tawhīd*, *shura*, Shariah rules and Islamic morality elements, which also contributes to its distinct features.

As a whole, Islamic corporate governance is based on the principles of *Tawhīd*, shuratic process, property rights and contractual obligations, which is different than the corporate governance models of the West. The BOD, the shareholders, the depositors, the managers and the Shariah board among others are considered to be key participants in the corporate governance of Islamic firms, most notably of all in IFIs. They are all responsible to ensure that the objectives of the corporation and the Shariah goals are met while maintaining Shariah compliancy and adhere to the values and ethics of Islam. Islamic banking operations and businesses are flourishing with exceptionally strong growth, and IFIs are mushrooming all around the world, and this calls for Shariah governance within an Islamic corporate governance framework with its own unique set of organizational structure.

The corporate governance framework is also given additional boosts with the introduction of Shariah governance within its framework. According to Nathan and Ribieri (2007: 477), it instils transparency, trust, credibility, philosophy, values, beliefs (*aqīdah*), Shariah and ethics (*akhlāq*). However, despite adding Islamic values, there are also criticisms that pertain to the Shariah board. Kahf (2004: 26) noted that a number of Shariah advisors are becoming "bankers' window dressers and overstretching the rules of Shariah to provide easy fatwa for the new breed of bankers". There is no evidence to support this statement; nevertheless, it is a negative perception that should be expunged, which is possible by implementing a Shariah governance that is fair and just.

By having strong Shariah governance, credibility of IFIs will also be strengthened. A Shariah governance framework must have the ability to cover the issues that relate to the foregone discourse. The standard and guidelines published by AAIOFI and IFSB are essential in order to improve and harmonize all Shariah governance practices and can also be used to resolve numerous issues pertaining to it. The foregone discussion suggests that there are additions and upgrades needed in today's Shariah governance framework as to further the growth of the Islamic finance sector. Thus, more research is required to explore all the current Shariah governance practices as to identify all the issues that affect them and to offer guidelines that would ensure the best practice of Shariah governance within Islamic financial firms.

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Daing Maruak is Senior Lecturer at the Academy of Contemporary Islamic Studies (ACIS). He has been with Universiti Teknologi MARA (UiTM) since 2008 and since then has served various departments. He obtained a degree in Theology of Philosophy from the University of Al-Azhar, Cairo, Egypt, in 2000. He is a holder of a master degree in Islamic Banking, Finance and Management from the University of Loughborough, UK. Currently, he is studying Islamic finance, majoring in corporate governance for his Ph.D. at Universiti Utara Malaysia. His areas of interest include Islamic banking, finance and religious studies. He is now actively writing articles and

chapters in books. His research paper has been published in the International Journal of Academic Research in Business and Social Sciences. He has also won several medals in various innovation competitions. He also involved in several community projects.

Dr. Zakaria Abas is Professor of Strategic Management Accounting at Tunku Puteri Intan Safinaz School of Accountancy (TISSA), UUM College of Business, Universiti Utara Malaysia. He is Fellow of Institute Professional Accountant (FIPA), Australia, and currently, attached as Director to the Mahathir Mohamad Institute of Thoughts (IPDM). Prior to this, he was with the Centre of University-Industry Collaboration, Universiti Utara Malaysia, as Principal Research Fellow. He has served as Special Advisor to the Honourable Minister of Higher Education from 1 October 2010 till 31 September 2012. His roles as Advisor, among others, to give advice on the formulation of policy on establishing sustainable strategic collaboration initiatives among universities, community and industries, in light of facilitating the successful implementation of National Higher Education Strategic Planning for the Critical Agenda Project Academia-Industry. Currently, he is actively engaged in top-down policy research granted by the Malaysia Economic Planning Unit, Prime Minister Department and the Ministry of Higher Education, Malaysia, as well as the State Governments of Kedah and Perlis. Internationally, he served as Advisory Board Member for the World Association of Cooperative Education and Integrated Learning (WACE), International Satellite Office at Suranaree University of Technology, Nakhon Ratchasima, Thailand. He has published widely in his areas of interest, namely strategic management accounting, knowledge transformation management, performance management system and quality management.

Ahmad Khilmy b Abdul Rahim is currently Senior Lecturer at Islamic Business School (IBS), UUM. He holds a Professional Certificate of Islamic Financial Planner (IFP) in 2013 and Certified Qualification in Islamic Finance (CQIF, Islamic Wealth) in 2014 from IBFIM and FPAM. He was graduated from International Islamic University Malaysia (IIUM), in 1996 in Fiqh and Usul Fiqh. He later obtained Master of Shariah from the University of Malaya (2005) and the Ph.D. degree in Islamic Finance and Banking from Universiti Utara Malaysia (UUM) in 2013. His area of research is Islamic finance, Islamic wealth management and Islamic laws of contracts. His research focuses on Shariah issues, juristic discussion and contemporary issues related to Islamic finance and Islamic wealth management. Currently, he holds a position as Professional Programme Coordinator at the Islamic Business School (IBS), UUM.

Azyyati Anuar is currently Senior Lecturer at the Faculty of Business Management. She has served Universiti Teknologi MARA since 2008. She graduated in 2018 with a Ph.D. in Operation Management from Universiti Utara Malaysia. Her areas of interest include lean health care, entrepreneurship, sustainability and marketing. She also involved in several community projects such as Program Kesedaran Sosial and Program Jalinan Kerjasama. She was qualified as one of the SME's Business Counsellor Trainer. She is now actively writing articles and chapters in books. Her research papers have appeared in the International Journal of Supply Chain Management, Journal of Information System and Technology Management and International Journal of Academic Research in Business and Social Sciences. She also won several medals in innovation competitions.

Mas Aida Abd Rahim is Lecturer at Universiti Teknologi Mara (UiTM), Merbok, Kedah, under the Academy of Language Studies. She obtained her first degree in language and literature from Universiti Tun Abdul Razak and her master's degree from Universiti Utara Malaysia (UUM) in Applied Linguistic. Her interest is more on literature where she found that this is a great field for her to learn more about language and make it as one of her passions in teaching and learning. Her journal article has been published in the International Journal Development Research (IJDR).

Part III
Risk Management Issues in Organizations

Japanese Food Company Supply Chain in Malaysia: Its Structure and Risk Management Strategies

Rafisah Mat Radzi, Intan Marzita Saidon and Nadzri Ab Ghani

Introduction

Supply chains are structured in various ways and also involved many risks. Many internal and external factors can impact on a business's ability to maintain its operations and serve its customers. While different industries vary in their practices in terms of mitigating risks, many researchers contend that risk in the food supply chain is more complex than other industries. The unique features of the food industry such as the perishable nature of food products differentiate it from other sectors of the economy and have intensified the need for an efficient supply chain. Due to the complexities in risks to the food supply chain, food processing companies in Malaysia are encouraged to integrate their supply chains efficiently, as spelled out in the nation's Third Industrial Master Plan (2006–2020). Therefore, in improving supply chain integration, this chapter will examine the structure of the food supply chain as used by Japanese food companies in Malaysia, considering Japan is widely regarded as a supply chain superpower (Inagaki & Kuroda, 2007). Further, the major risks and mitigation practices that Japanese food companies experience in Malaysia will be closely studied.

The following sections will, in order, provide a literature review. It is then followed by an overview of the food industry in Malaysia and outline of the methodology used in this study. Finally, structure of the food supply chain including risk mitigation as practiced by Japanese food companies in Malaysia will be discussed. This analysis will help domestic food companies improve and manage their food supply chains

R. Mat Radzi (✉)
Universiti Sains Malaysia, Minden, Pulau Pinang, Malaysia
e-mail: Rafisah@hotmail.com

I. M. Saidon · N. Ab Ghani
Universiti Teknologi MARA (UiTM) Kedah, Merbok, Malaysia

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and provide data to Japanese food companies and other companies around the world about their investment strategy in Malaysia's food industry.

An Overview of the Food Industry in Malaysia

The development of the food industry in developing countries may be viewed as strategic in the sense of providing sources of revenue as well as generating employment. The food industry contributes about 10–30% of a developing country's wealth and generates approximately 15–50% employment opportunities (Mc Cullough, Pingali, & Stamoulis, 2008). The percentage of food processing exports rose from 6.6% in 1991 to 10.6% in 2006, reflecting the food industry's significant contribution to the economies of developing countries (Jogwanich & Magtibay-Ramos, 2009). In fact, it is expected that to meet the needs of population growth in developing countries, it has been estimated that the food industry needs to boost its production by 70–100% by the year 2050 (Zimba, 2013).

In Malaysia, the significant influence of the food processing industry to the economy is evidenced by government policies supporting the development of this industry. The First Industrial Master Plan 1986–1995 laid the foundations for the growth of the manufacturing sector. The Master Plan emphasized the promotion of resource-based industries. Accordingly, the food processing industry was identified as the top priority for development because this industry is strongly linked to other sectors of the Malaysian economy (Ahmed, 2012). It was reported that local production of food rose to approximately 4.2% per annum. However, the increment failed to match domestic demand and resulted in rising imports, especially during 1990–1995 (Fig. 1). During this period, Malaysia experienced a persistent food trade imbalance

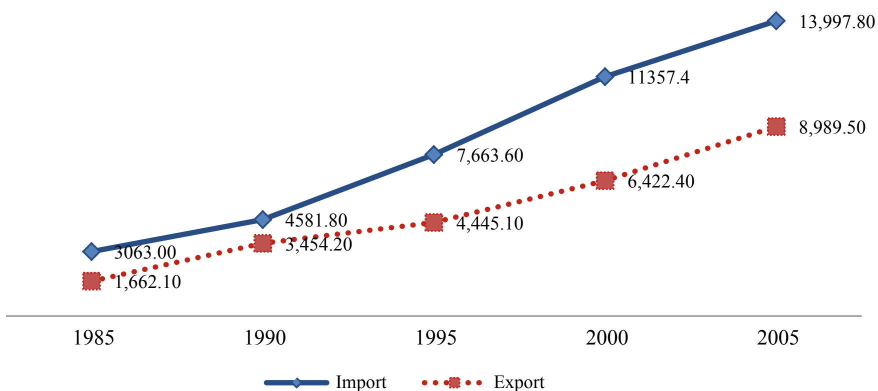

Fig. 1 Imports and exports of food in Malaysia, 1985–2005 (RM Million). *Source* Ministry of International Trade and Industry Report, various years

in that the demand for food items rose faster than the supply (Ismail, Sidique, & Radam, 2008).

The Second Industrial Master Plan 1996–2005 was launched to the manufacturing sector's growth. During this period, the main focus was to develop and implement policies and strategies to transform the manufacturing sector into a resilient, broad-based, and internationally competitive one. Despite the increasing contribution of the food processing industry to Malaysia's total manufacturing output from 6.1% in 1996 to 9.9% in 2000, Malaysia remained a net importer (Fig. 1). The rising level of imports was caused by the increasing demand for primary and food products from the downstream processing (MITI, 1996).

Currently, the Malaysian government through the Third Industrial Master Plan 2006–2020 expects the food industry to expand its capacity and enhance its competitiveness so that domestic demand can be met as well as increase the level of exports. The food processing industry is planned to be one of the major contributors to export earnings during this period. The production of food commodities is expected to grow at an average rate of 7.6% per year. This could be achieved through advances in human resources, and technology, enhanced research and development, high value added to domestically oriented goods and services, exports and niche products, and maintaining high-quality standards (MITI, 2006).

Although the food manufacturing industry in Malaysia plays a significant role in the economy, the industry is dominated by small- and medium-sized enterprises. Food processors in Malaysia are experiencing several problems such as traditional or obsolete technologies, substandard quality of raw materials, and low levels of product innovation (Senik, 2010). Due to its small-scale nature, the local food processing sector is not able to cater for increasing demand, and therefore, Malaysia, currently, has a negative trade balance for edible products and preparations (ETP, 2010). Therefore, the government wanted to see growth in the local food processing sector, especially through the utilization of local raw materials. Malaysia's government has always encouraged supply chain integration in business operations, and this was spelled out in the Third Industrial Master Plan (2006–2020) where one of the main objectives is to improve the country's global competitiveness (MITI, 2006). Improvements in the supply chain are important in helping Malaysia moving toward greater self-sufficiency in food.

Literature Review

Supply chain management encompasses every effort involved in producing and delivering a final product or service, from the supplier's supplier to the customer's customer. It includes managing supply and demand, sourcing raw materials and parts, manufacturing and assembly, warehousing and inventory tracking, order entry and order management, distribution across all channels, and delivery to the customer (The Supply Chain Council in Westbrook, 2002). Simply put supply chains link suppliers, customers, shippers, and service providers together in the business process.

The scope of the supply chain can be ascertained in terms of the number of firms involved in the supply chain and activities and functions involved (Cooper, Lambert, & Pagh, 1997). Since the chain may vary greatly from industry to industry and firm to firm (Ganeshan & Harrison, 1995), it can be created from a very simple linkage that encompasses raw materials procured from a supplier, transformed into finished goods in specific stages, and then distributed to customers (see Fig. 2). However, realistic supply chains have multiple end products with shared components, facilities, and capacities. The flow of materials is not always along an arborescent because various modes of transportation may have to be considered, and bills of materials for the end items may be both deep and large (Ganeshan & Harrison, 1995).

In this regard, the basic group of participants creates an extended supply chain (Hugos, 2006) and this supply chain may consist of primary and supporting members (Lambert, Stock, & Ellram, 1998). In fact, the supply chain structure can be grouped into three basic parts, i.e., upstream, internal, and downstream (Roth, 2003). The upstream supply chain part encompasses a business organization's first-tier suppliers

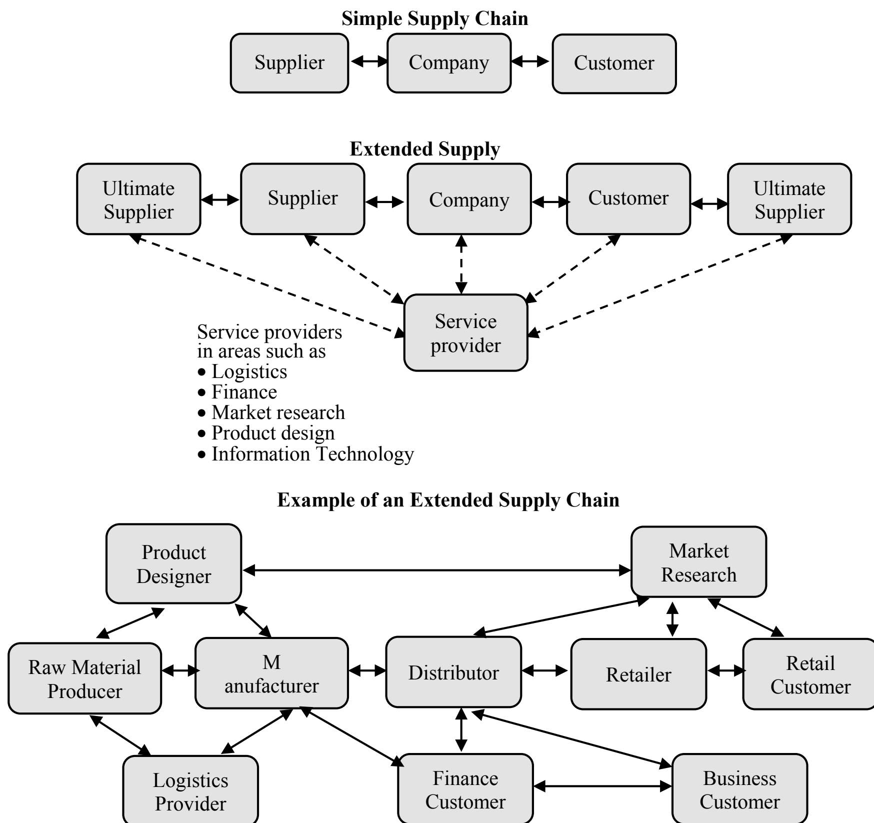

Fig. 2 Supply chain structure and its components. *Source* Hugos (2006, p. 27)

and their suppliers. Such a relationship can be extended, in several tiers, all the way to the origin of the material (e.g., mining ores, growing crops). Internal supply chain includes all the processes used by an organization in transforming the inputs shipped by the suppliers into outputs, from the time materials enter the organization to the time that the finished product goes to distribution, outside the organization. In the downstream supply chain, this structure includes all the processes involved in distributing and delivering the products to customers. These studies have shown that there is no "proven path" to develop frameworks or structures for effective supply chain.

In an attempt to achieve supply chain management excellence, various risks may arise along the chain which can be classified into two broad categories (Kleindorfer & Saad, 2005). Firstly, risks may emerge from the problems of coordinating supply and demand. A failure of any one element in a supply chain potentially causes disruptions for all partnering companies upstream and downstream (Yang & Yang, 2010). Secondly, risks can arise from disruptions to normal activities which may be due to natural disasters, strikes and economic disruptions, or deliberate acts of sabotage, including terrorists. However, most of the literature finds that the supply chain management of food production is more complex than other industries. The special characteristics of products, production processes in food, and actors in the chain itself have added to the complexity and dynamism of food supply chains. The quality deterioration (perishability) and quality variation of food products, production, and distribution management in food supply chains are intrinsically dynamic in the food supply chain (Grunow & Vorst, 2010). Instead of quality of agriculture depending on climate conditions (Salin, 1998), the very short shelf life of food produce (Negi & Anand, 2015) and characteristics of (fresh) food products change over time have important implications for the management of processes in the supply chain (Linnemann, Benner, Verkerk, & Boekel, 2006). Regardless of whether the supply chain is for fresh agricultural products or processed food products, van der Vorst (2000) stressed that both types of chain realize that original good quality products can easily deteriorate because of an inconsiderate action of another actor. This means food safety and high-quality products are not the sole responsibility of individual organizations, but of the entire food supply chain. Different actors in the food chain as well as various consumers and consumer groups have different perspectives on food product attributes, posing extra challenges to the proper and logical alignment of processes in the chain (Linnemann et al., 2006). Considering the food supply chain's unique and distinctive nature, the study of managing risks in it is still relevant and a major topic in the literature.

Methodology

This research employs a constructivist ontology using qualitative methodology. Following Leung (1999) constructivism attempts to investigate the roots of social

phenomena, each investigation being unique and its findings not able to generalizable to another similar phenomenon. Brand (2009) emphasizes the value of qualitative methodology in obtaining a better understanding of the "how" and "why" of respondents' perceptions which cannot be elicited easily from large-scale questionnaires. This method allows researchers to explore an issue in-depth rather than with an emphasis on the breadth (Daniels & Cannice 2004).

A total of ten (10) Japanese food companies, representing 56% of those listed in Japan External Trade Organizations (JETRO) were involved in this analysis. There are currently 18 Japanese food and beverage manufacturers operating in Malaysia (JETRO 2011). Twenty (20) senior or middle managers with direct responsibility for supply chain management logistics in these businesses were preferred for interview following the advice of Chow et al. (2008). To document the issues concerning supply chain practices, perceptions originating from middle-line managers are important because they deal directly with supply chain processes and network structures, and the technical/behavioral components of management systems (Chow et al., 2008). Therefore, semi-structured interviews were conducted at the managerial level and most of them have worked in the industry for more than ten years. The designations and experiences of the managers are important because these reflect their vast knowledge and management skills in handling supply chain issues that arise in their companies.

Following standard practice in qualitative research (Miles & Huberman, 1994), the data obtained from the interviews were read reiteratively and analyzed rigorously through an inductive process of identifying the common and salient themes. The process of data analysis involved the use of NVivo 10, software employed to analyze qualitative data. A final but critical step in the inductive approach requires an assessment of the trustworthiness of the data. As a means to assess validity, other researchers independently developed the coding process and compared the findings with the initial results. Should there be any observed discrepancies, the researchers collaborate to resolve the anomalies.

Findings and Discussion

Based on the Japanese companies' experience of managing their supply chain and review of relevant literature, this chapter described and explained the structure of the food supply chain as implemented in Malaysia. As well, this chapter has provided some interesting and useful insights into how Japanese food companies cope with several major risks that are most likely to seriously compromise their operations. These themes are explained in more detail in the subsections that follow.

The Structure of the Japanese Food Supply Chain

Based on rich data obtained from semi-structured interviews, this chapter has identified that the outstanding elements in the Japanese food supply chain in Malaysia are the type of structure, level of integration and strategic relationships among parties in the chain. These characteristics act as a platform in achieving supply chain management excellence in the Japanese food and beverage companies operating in Malaysia.

Short and Simple Supply Chain Structure

In general, the supply chain encompasses raw materials which are procured from suppliers, transformed into finished goods in stages, and then distributed and sold to customers. The chain can be created from a very simple linkage to the extended supply that consists of two tiers or an extended supply chain comprising several tiers. In fact, the structure of the supply chain can be created in many ways, either upstream, internal, or downstream depending on the nature of the business and the overall industry. However, Japanese food companies in Malaysia prefer to have a supply chain that is as short and simple as possible. Only several parties are involved in the chain as illustrated in Fig. 3. Suppliers refer to the supply chain members who in turn provide raw materials to the food manufacturer. The Japanese food and beverage companies act as the food manufacturer in this chain. They handle the

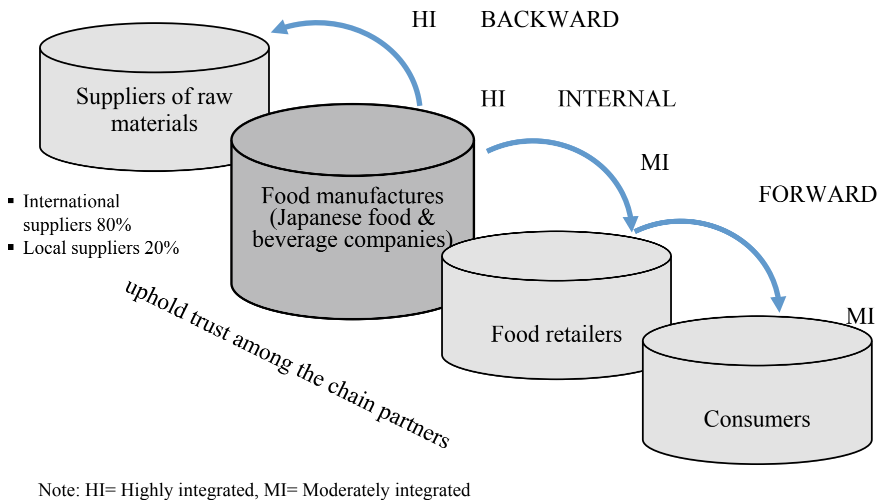

Fig. 3 The structure of Japanese food companies' supply chain in Malaysia. *Source* Based on survey

production process, product development and are responsible for the quality of food products that reach the end consumers. Retailers refer to the supply chain members who sell the food products directly to end consumers, who in effect are the end users of the food products. Obviously, the main unique element of the Japanese food supply chain as compared to other typical food supply chains is that food distributors do not function as the main actor in the chain.

Considering the nature of food products which are sensitive to temperature and can deteriorate easily, a long chain may expose a company to more miscommunication among the chain partners and complicate the material handling processes. Consequently, a short and simple structure is chosen by Japanese food companies because it enables them to ensure the final products reach the end consumers at the right time with the right quantity and quality. In addition, the structure helps the supply chain to stay agile and lean in the effort to reduce costs, increase revenue, and minimize assets or overheads during the production processes. By implementing this structure, Japanese food companies are able to achieve a time-efficient food supply chain and in the meantime provide benefits to all parties in the chain.

One of the main values that were identified as being practiced by Japanese food companies is that preserving food quality is vital to ensuring that food products or processed food will always look and taste the same. Japanese food companies will try to retain as much as possible the ingredients used in processing food from the same suppliers. Since they never compromise on food quality, the level of dependence on international suppliers is high. Almost all (80%) of the main raw materials are supplied by local suppliers while the remaining 20% are imported from overseas. Japanese food companies in Malaysia believe that preserving quality products will help to maintain customer satisfaction and loyalty and reduce the risk and cost of replacing faulty goods or products.

Strategic Level of Integration

In general, supply chain integration helps companies to integrate process activities internally as well as integrating externally with customers and suppliers. Integrated supply chain may help to tie the whole network together, which could eventually help to reduce perennial supply chain challenges such as poor demand management and forecasting as well as inadequate formation of customer and supplier relationships. In integrating the industry value chain, basically, companies apply forward integration, backward integration, or balance integration (Jurevicius, 2013). While forward integration is a strategy where firms increase control over their previous customers, backward integration is a strategy where firms increase control over their previous suppliers. However, in the case of the Japanese food companies, they find that balance integration—a strategy that combines forward and backward—fits them well, with different degree levels of integration. In an attempt to achieve supply chain management excellence, their supply chain can be described as high backward integration and moderate forward integration. Japanese food companies maintain

high-level integration with suppliers since they believe that high-quality products can be manufactured only from high-quality raw materials. As such, preserving food quality is vital to ensuring that food products or processed food will always look and taste the same. Japanese food companies will try to retain as much as possible the ingredients used in processing food from the same suppliers or reliable suppliers who have a good record of consistently providing the same good quality over many years. Preserving quality products will help to retain customers' satisfaction and their loyalty to the business, and reduce the risks and costs of replacing faulty goods or products. In this case, a moderate level of integration with customers will suffice.

Build and Uphold Trust Among the Chain Partners

Building and upholding trust between the parties in the chain is another unique characteristic of the Japanese companies' food supply chain. This characteristic mirrored the discussion by Handfield and Nichols (1999) about the importance of a trusting relationship and the need to share information and assets in order to excel in a strategic relationship. The Japanese companies in Malaysia ensure that information flows smoothly along the chain so that each party in the chain can retrieve and disseminate information effectively. This will provide leverages to each party in the chain in making strategic decisions in their daily operations. To them, information sharing is a prerequisite for building trust. As such, suppliers and food retailers not only receive actual orders from the companies but also furnish them with other information concerning issues of production status, transportation availability, and demand data. Expertise of all chain partners has been embedded in manufacturing the food products. As a result, all parties in the chain work together in a harmonious way and help eradicate any uncertainties. In general, businesses' operations are based on mutual agreement between parties involved. An official contract is not mandatory; only recently a few companies started to have a legally binding contract between the parties in the chain in order to fulfill the corporate governance procedures.

Risk in Managing the Supply Chain: How Do Japanese Food Companies Mitigate Them?

Supply chains are at the mercy of various forms of risk. Previously, supply chain disruptions have been claimed to wield an adverse effect on shareholders' investment (Hendricks & Singhal, 2003) and companies' operating performance (Hendricks & Singhal, 2005). Thus, identifying the possible risks and planning ways to mitigate those risks in order to withstand supply chain disruptions is essential in today's business world. As for the Japanese food companies operating in Malaysia, there

are five major risks: production, demand, purchase price, procurement, and *halal*[1] requirement risks, which could possibly disrupt the supply chain. On these issues, Japanese food companies have developed their own unique practices in mitigating the risks, as summarized in Table 1.

i. *Production risks*

While numerous risks exist in every stage of production carried out by each participant along the production chain, generally, most managers of Japanese food companies contend that production risks are the most difficult uncertainties to deal with.

Table 1 Summary of various risks and mitigation strategies implemented by Japanese food companies in Malaysia

	Types of risks	Mitigation practices
1	**PRODUCTION RISKS** ▪ Machine breakdown ▪ Shortage of skilled/experienced production operators ▪ Limited storage space ▪ Maintaining good quality of packaging for products	**JAPANESE MANAGEMENT STYLE** ▪ Regular maintenance schedule ▪ On-the-job training ▪ Multi-skilling ▪ Just-in-Time (JiT) production ▪ Good management practices (5s, JiT, *gemba*)
2	**PURCHASE PRICE RISKS** ▪ Price volatility ▪ Foreign exchange fluctuation	**PURCHASE PRICE STRATEGY** ▪ Price lock agreement ▪ Lock quantity ordered ▪ Official contract with suppliers ▪ Close relationship with suppliers
3	***HALAL* COMPLIANCE RISKS** ▪ Meet *halal* standards (JAKIM)	**UPHOLD QUALITY STANDARD** ▪ Close relationship with JAKIM ▪ Meet quality standard (ISO 9000, ASQUA)
4	**DEMAND RISKS** ▪ Fluctuation in demand	**APPLICATION OF INFORMATION TECHNOLOGY (IT)** ▪ Accurate forecasting ▪ Frequent updates
5	**PROCUREMENT RISKS** ▪ Sustaining the good or high quality of raw materials	**INTEGRATION WITH SUPPLIERS** ▪ Procurement through loyal suppliers ▪ Share information with suppliers ▪ Timely payment to suppliers ▪ Yearly evaluation of suppliers' performance

Source Based on survey

[1]Literally means permissible. It refers to food being prepared in ways that are permissible in Islamic law.

Several sources of production risks emanate from internal business operations. First, machine breakdown is the main risk to production since Japanese food companies are high-technology oriented. In capturing the inherent heterogeneity of the quality of product batches, Japanese food companies rely entirely on machines and trustworthy technology. Instead of resulting in an uneven quality or standard, machine breakdown has led to problems of maintaining good quality packaging. Second, the scarcity of skilled and experienced production operators has meant that Japanese food companies in Malaysia depend largely on migrant workers for their burgeoning industrial expansion plans. The demand for foreign workers is not only associated with people's skills and capabilities but also with employees' education and training levels. The current Malaysian workforce in the manufacturing firms mostly consists of people with minimum qualifications, and problems arise regarding language, communication, and attitudes to learning new skills. Third, most managers working for Japanese food companies in Malaysia assert that inventory management is in a somewhat critical state because they have limited storage areas and facilities.

In managing production risks, the Japanese companies employ effective machine maintenance practices. A maintenance program which includes routine activities such as cleaning and lubrication as well as preventive measures such as regular replacement schedule for essential machine parts could prevent hazardous conditions and costly repairs from taking place. Records of inspections, replacement, and significant findings during the maintenance process are well maintained for future reference. In addition to effective machine maintenance practices, certain Japanese management styles were identified as being the critical success factor for overcoming risks. Employing the Just-in-Time (JIT) philosophy in the production process and planning helps to overcome issues concerning limited storage space. Meanwhile, implementing good manufacturing practices such as the 5S methodology, i.e., *seiri* (organization), *seiton* (neatness), *seiso* (cleaning), *seiketsu* (standardization), and *shitsuke* (discipline) in the daily operations helps to organize the production processes in a clean, efficient, and safe manner. Further, Japanese food companies promote *gemba* or manufacturing floor activities. The idea behind *gemba* is that managers walk around the work area and can see first-hand how food processes are operating or to understand the full impact of a problem that has occurred. The Japanese food companies also have created their own training program to improve employees' skills and competencies. The advantage of this model is that it is easy to initiate training programs and it costs less because the additional purchase of machines or appliances for training is not necessary.

Further, Japanese food companies also maintain close relationships with suppliers of raw materials in mitigating production risks. When faced with unexpected disruptions or extremely high demand of food products during festive seasons, the Japanese food companies can depend on valuable guidance given by the suppliers. Advice in terms of availability of existing raw materials, possibility of having alternative raw materials and proper techniques that need to be applied in order to maintain the freshness and quality of raw materials, play an important role in ensuring the supply chain operates in a seamless way.

ii. *Purchase price risks*

The raw materials used by the Japanese food companies originate from a mixture of local and overseas sources. While a small percentage of raw materials is obtained from overseas, these imported materials are considered core items for their production processes. The importance of having raw materials to maintain or improve the end product's quality has resulted in Japanese food companies being exposed to purchase price risk, which emanates from two sources. The first is the price volatility of raw materials. The nature of the food industry and industrial production depends on trade in raw materials such as minerals, agricultural, and natural resources despite the fluctuations in supply that may occur. These sources' prices vary for many reasons such as yield variations, typically owing to weather, climate, and policies in the countries that produce and export them. The second concerns the prices of imported or raw materials that are subjected to foreign exchange rates. Because international purchasing always involves a series of purchases, companies, in certain cases, usually buy the raw materials or goods in bulk, which requires larger monetary transactions. These transactions are exposed to greater risks in the form of currency fluctuations. Moreover, cross-border transactions result in complicated procedures and processes, which expose a company to many additional risks. Both sources of production risk may have serious implications for production costs which eventually put the companies in an uncompetitive profit margin position compared to their competitors.

The ill-effects of the purchase price risk are controlled through the use of a price and quantity lock strategy. This strategy refers to the mutual understanding between the Japanese food and beverage companies and their suppliers regarding the quoted price when the orders for the raw materials are generated. Should there be drastic and/or adverse changes in the price of raw materials, suppliers may allow the Japanese companies a few months to adjust their production plans accordingly before implementing the new price. Alternatively, the suppliers may continue charging the first quoted price up to the maximum quantity that has been locked in or agreed to earlier. Although having an official contract specifying the quoted price is the best way to control this risk, most companies choose not to do so. The Japanese companies insist that a long-term and close relationship with suppliers enables them to benefit from the price and quantity lock strategy.

iii. *Halal compliance risks*

Malaysia is a country located in Southeast Asia and its official religion is Islam. Malaysia is very concerned about *halal* compliance in the production of food products. In fact, over the past few decades, Malaysia has become a world leader in the global expansion of *halal* markets. Through Malaysian Standard: *halal* food production, preparation and storage-general guidelines, known as MS 1500:2004, the proper production, preparation, handling, and storage methods of *halal* food were established (Janis, 2004). The certification process will normally take about two to three months, depending on whether the certification is for a new product or it simply renews an existing certification. Food producers operating in Malaysia are

encouraged to apply for the *halal* certification as it can widen their market to include Muslim consumers.

Having a proper *halal* certification could add considerable value to businesses operating in Malaysia. *Halal* certification provides assurance to Muslim consumers that the certain food products and their preparation conform to *Shariah* (Islamic) law. As for non-Muslims, *halal* certification may reflect the product is of good quality because the production of *halal* certified products must strictly follow good manufacturing practices (GMP) and good hygiene practices (GHP). Therefore, any slight diversion from the *halal* standard guidelines will expose the Japanese companies to a risk referred to as *halal* compliance risks.

Acknowledging the importance of this issue, upholding the standard set by JAKIM (Department of Islamic Development) as well as other quality standard setters, for example, ISO 9000 and ASQUA, is vital for the Japanese food and beverage companies operating in Malaysia. These businesses must always ensure that the suppliers of raw materials will only supply *halal* goods and have *halal* confirmation certificates for each type of raw materials supplied to them. Apart from following procedures documented in the Malaysian *Halal* Certification Manual, frequent meetings with JAKIM are an effective way for the Japanese companies to get updates on current *halal* issues. In addition, printing the *halal* logo on the packaging of their products is also a strategic tool to garner consumers' confidence in their food products.

iv. *Demand risk*

Demand risk refers to external risks faced by the Japanese food companies. There are two main drivers of demand risks. The first stems from unpredictable changes in consumer demand that ultimately result in demand volatility. Managers in Japanese companies find that in the food industry, consumers regularly change their behavior—new preferences and fads dominate many people's purchase decisions. In this regard, retailers and consumers will not wait, opting instead to switch to products and manufacturers that do meet their needs. The second driver for demand risk is poor internal coordination and communication across functions. Delay in sharing information will result in ineffective management and poor communication across various departments or units within the companies. All these tend to create a high level of non-value-added activities, wastage and time loss in certain production processes.

This study revealed demand risks can be offset and managed through frequent updates and executing forecasting information processes accurately. One way to achieve this is by allowing all databases in each and every department in the supply chain to be interconnected. All raw materials and finished products are coded to indicate the batch number, description of the item and the location. Furthermore, the inflow and outflow activities of raw materials and finished products are recorded in the computer system in order to facilitate tracking of inventory levels, orders, sales, and deliveries. The efficient monitoring of material flows (delivery and sales) and information flows (demand forecasts, production schedules, and inventory level information) helps to mitigate this risk. In addition, the effective system through the utilization of information technology (IT) enables Japanese food companies to match

demand and supply. Therefore, affected parties could react quickly to any disruptive incidents along the supply chain.

v. *Procurement risks*

As noted earlier, the unique value as being practiced by Japanese food companies in Malaysia is to preserve food quality so that food products or processed foods will always look and taste the same. As such, these Japanese businesses believe that by maintaining the same ingredients with the same (and proven) suppliers, this will produce a consistent standard of quality products for many years to come. For them, mixing or substitution of raw materials is a somewhat uncommon and undesired practice because it can change the original taste. Here, the Japanese food companies are heavily dependent on their suppliers, meaning that risk in procurement is one of the main dangers in the Japanese companies' food supply chain. Supply delivery can be interrupted by many factors, including adverse weather, infrastructure issues, price increases or damage to or problems occurring in a supplier's location. Loss of even one dependable supplier can affect the quality of products, consistency, and good name of a food service provider, ultimately leading to a loss of income. Failure to deliver the required quality of raw materials by suppliers has resulted in Japanese food companies failing to comply with required processes to produce high-quality end products.

In mitigating the procurement risk, Japanese food companies have formulated strategies through trade relationships with suppliers in several ways. First, by implementing procurement through loyal suppliers, Japanese food companies are able to receive the exact quantity and quality needs over the life of the contract. This is particularly true for long-term contracts where demand for the food products may be heavily tied to unforeseen market events. Second, working closely with raw materials suppliers is beneficial as it enables sharing of information on preserving the good quality storage of raw materials. In many cases, suppliers provide much valuable guidance with reference to proper techniques in maintaining raw materials' freshness and edibility. Third, it is important to ensure suppliers are paid in a timely manner. In fact, the management of payments to suppliers is relatively easy to undertake as there are only a few suppliers operating in the Japanese companies' food supply chain and they are loyal. Having a small number of suppliers helps the companies to concentrate on accountability, increase standardization, improve visibility, and strengthen relationships. Fourth and lastly, there is the issue of yearly evaluation of suppliers' performance. As viewed by managers in Japanese food companies, conducting an evaluation is important for a continuous and smooth flow of supplies coupled with meeting the demanded quality of raw materials. As a result, a company's procurement department needs to be well integrated with the suppliers of raw materials because the quality of raw materials must be continuously evaluated and checked so that suppliers are doing what is expected of them.

Conclusion

Managing the food supply chain has received significant attention in recent years especially in global emerging markets. This research has generated valuable insights into the Japanese food supply chain and how it functions in Malaysia. Comprehensively, understanding the critical supply chain management issues may help local companies to evaluate their current supply chain management practices and benchmark them with Japanese companies which operate as a supply chain superpower. The Japanese companies in Malaysia formulate three main strategic characteristics which act as a platform in achieving supply chain management excellence. Operating based on a short and simple supply chain structure, balance integration and uphold trust among the chain partners will help them to reduce costs, increase revenue, and minimize assets/overheads.

While supply chain risk tends to paralyze most supply chains, the Japanese food and beverage companies in Malaysia have recognized the need to put strategies and capabilities in place to identify, prioritize, and manage risks and opportunities across their entire food supply chains. Since many risks exist in the chain, Japanese food companies in Malaysia prioritize several areas of risk that should be managed properly. The most important five risks that are most likely to compromise businesses are, in the following order, production risk, purchase price risk, *halal* compliance risk, demand risk, and procurement risk. In mitigating those risks, the Japanese business management styles, for example, Just-in-Time, 5 s and *gemba* are present in companies' activities and management practices. They facilitate the successful integration of the food supply chain. It is evident that Japanese food companies place a high priority on building long-term partnerships with their suppliers.

Beyond the quality of the supplied goods and procurement needs, this relationship creates mutual information sharing which helps to preserve raw materials' safety, freshness, and edibility. In the meantime, creating a win-win relationship with suppliers and treating them as partners to grow the business has benefited the Japanese food companies in reducing procurement risks. The verification of *halal* requirement that goes beyond 'the tick box' approach has resulted in the Japanese food companies benefiting from the advantages of good factory design. These include, for example, compliance with Malaysia's food hygiene standards, reduction in manufacturing costs and better profit margins. Furthermore, success in managing food supply chain risks is mainly based on the advantages of having updated and/or trusted information technology systems. Computerized systems make it possible to set up reorder systems for raw products that are interconnected with other business departments, making purchase and sales transaction decision-making timely, accurate, and complete.

Finally, the input is crucial as different supply chains operating in various countries do require different strategies for risk mitigation; hence, a focus on specific constructs of strategies that suit a particular country is needed. While it is essential for local food companies to stay longer in the industry through the input they deliver or receive,

foreign companies worldwide may benefit from the input when considering their investment in Malaysia's food industry.

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Rafisah Mat Radzi is a senior lecturer at the School of Distance Education, Universiti Sains Malaysia. Currently, she is a visiting fellow at the School of Humanities and Social Sciences, UNSW Canberra, under the sponsorship provided by the Ministry of Education Malaysia. She obtained her Ph.D. in Business and Management from the University of South Australia in 2012. Rafisah's research has embraced a wide range of topics involving the capital market, corporate finance Islamic finance, and supply chain themes. Her current research projects are related to Sukuk (Islamic bonds) and social responsibility investment. Within the last five years, her projects were funded by two international sponsors, i.e., The Sumitomo Foundation and Chartered Institute of Management Accounts (CIMA), UK. Also, Rafisah received one national grant from the Ministry of Education Malaysia (Fundamental Research Grant Scheme) and a short-term grant from Universiti Sains Malaysia.

Intan Marzita Saidon is a senior lecturer at the Faculty of Accountancy, Universiti Teknologi MARA (UiTM) Kedah, Malaysia. She has more than twenty years of experience teaching various accounting courses in UiTM. She obtained her first degree from Northumbria University, UK and holds a Ph.D. from Curtin University, Australia. She is an associate member of the Malaysian Institute of Accountants. Her present research interests include ethics, strategic management, and accounting education.

Nadzri Ab Ghani is a senior lecturer at the Faculty of Accountancy, Universiti Teknologi MARA (UiTM), Kedah, Malaysia. He has been with UiTM for more than fifteen years, and before joining

UiTM, he was a lecturer at Institut Teknologi Tun Abdul Razak, Malaysia. He holds a Ph.D. in Corporate Governance (specifically in the area of whistle-blowing) from Curtin University, Australia. He is an active researcher and his research interests include whistle-blowing, supply chain management, and accounting education.

A New Dawn of Mobile Payments: Infrastructure, Challenges, Risks and Mitigating Factors

Manroshan Singh Bhatt, Muhammad Arief Siddiq Md Daud, Reza Aminosharei and Kim Mun Wong

Introduction

Throughout history of the human race, we have relied on many methods to facilitate our monetary transactions. From the humble barter system to shillings and paper money and to plastic cards like debit and credit cards, we have undergone sustained evolution in the way we obtain our goods and services. The pervading evolution of the day is mobile payment, an industry that started from scratch in 2015 and has since swept the entire world due to the nature of its revolutionary payment system. Mobile payment (also referred to as mobile money, mobile money transfer and mobile wallet) generally refers to payment services operated under financial regulation and performed from or via a mobile device.

Today, we see China leading the charge in mobile payment technology, and its two secret weapons are Tencent and Alibaba—two giant Chinese technology companies. It is ironic to think that the inventor of paper money, China, is trying to do away with banknotes and is all geared to become a cashless society. On 11 November 2017, in conjunction with its own Singles' Day celebration, Alibaba generated 168.2 billion Yuan ($25.3 billion) in sales (Bloomberg News, 2017). In a single day, Alibaba was able to obtain the entire yearly GDP of Estonia in 2017 (World Bank, 2019). It is reported that at the peak of the spending frenzy, the company was processing 256,000 transactions per second. Of this whopping number of transactions on that day, 90% were facilitated through mobile devices (Bloomberg News, 2017).

It is said that beggars in China do not accept cash, only mobile payment. Such has been the far-reaching effect of mobile payment in one of the world's largest nations. Convenience is key when it comes to this innovative payment method, and in China, there are very few things that one can buy or do in the absence of mobile payment.

M. S. Bhatt (✉) · M. A. S. Md Daud · R. Aminosharei · K. M. Wong
University of Malaya, Kuala Lumpur, Malaysia

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On the other end of the spectrum, mobile payment is a relatively new chapter in the long history of financial tech and with it carries its own risks. In general, risk is broadly defined as the possibility of an entity incurring a favourable event or losses. It can be classified into different areas such as strategic risk, financial risk, operational risk and compliance risk. In order to combat these risks, companies generally employ various risk mitigations or risk management strategies which include the process of identifying, evaluating and then taking appropriate steps to handle these risks. This concept is explored further in the paper with more in-depth case study examples in China. This leads to the following questions: Why is mobile payment so big in China and how can businesses make use of certain factors to reap the benefits and minimise its potential risks?

The Surge in Mobile Payment: China's Experience

According to Aldama (2017), the primary factor contributing to the surge in mobile payment in China is its convenience and simplicity. He contends that the mechanism of mobile payment introduced by Alipay and WeChat Pay is also quite user-friendly. Firstly, users need to link their banking account to the mobile application. With effect from 1 July 2016, the Central Bank of China requires all mobile payment users to register themselves using their real names to continue using the service (Wu, 2016). This new regulation is crucial in accordance with the growing importance of mobile payment to China's economy. After authenticating themselves, users can purchase anything from any participating businesses which offer the option of mobile payment (Aldama, 2017). Every user has his/her own unique QR code and payment can be made by having the merchant scan the user's QR code using a point of sale (POS) device (Aldama, 2017). Conversely, smaller vendors who do not own a POS device can simply print out their QR code and customers can complete payment by scanning the QR code provided.

Mobile payment applications also offer a few other services which ease transactions. For instance, one can split his or her bill within seconds at the end of a meal with a group of friends without going through the hassle of dividing the bill using physical banknotes (Aldama, 2017). Besides simplifying purchases, applications like Alipay can aid consumers in finding the nearest location to buy goods and services of their choice. This greatly helps those who have difficulties in finding a place to buy certain products as they can now immediately and conveniently search a location to buy the intended using their mobile payment application. Moreover, one of the more impressive functions of this payment is that it increases the consumers' confidence in the product they buy. For example, a customer intending to buy fish from a wet market can now source for information about the fish, like the species and origin of the fish, by merely scanning the QR code of the fish (Aldama, 2017), hence, helping to clear any doubt in the buyer's mind.

Secondly, the lack of infrastructure to facilitate credit card payments in China has also helped to boost the popularity of mobile payment (Knowledge@Wharton,

2018). Underdevelopment in the financial system in China has led to the meteoric rise of mobile payment methods. While their Western counterparts had favoured credit card payment years before China, the Chinese have skipped this step and leapfrogged to the era of mobile payment (Cheng, 2017; Knowledge@Wharton, 2018). The giant leap can be explained in a few ways. Firstly, the idea of owning a credit card among the Chinese is not well-perceived by the older generations (Kuhn, 2017; The Economist, 2016). Conventional Chinese are taught to save, and borrowing money is shameful (Kuhn, 2017; The Economist, 2016). Therefore, spending money using a credit card, which represents an amount of money that does not belong to you, is an act against the norm of the elderly. Secondly, not everyone is eligible to apply for a credit card (Van Dyke, 2017). Only individuals with high income or businessmen are entitled to apply for credit cards from banks. The reason is that banks are highly concerned about the default risk of credit card owners and only issue cards to customers with really low chances of not paying back their debt, after a credit rating assessment is done (Van Dyke, 2017). This criterion alone means that anyone without a good rating will most probably never get the chance to own a credit card again. The creation of this QR code mobile payment method fills in the gap left behind by the discriminatory credit card ownership problem (Cheng, 2017). The convenience of this method, which only requires one to have a bank account and a smartphone, allows everyone to access this payment channel (Aldama, 2017). Besides, smartphones in China have seen a fall in prices with the emergence of local brands like Xiaomi and OnePlus One, hence, paving the way for lower-income people to utilise mobile payment. The lack of credit card payment infrastructure has strongly benefited China's mobile payment development, and the transition from the cash medium to mobile payment is not interrupted by the introduction of credit cards (Cheng, 2017). Comparatively, in Western societies, the credit card medium is seen as the prevalent medium replacing cash (Van Hoek, 2017). This widespread adoption of credit cards in the West means that other parts of the world need time for this transition and to evolve from credit card usage to mobile payment (Knowledge@Wharton, 2018). As credit card interest payment serves as a revenue stream for banks, it is undeniable that this transition to mobile payment method is seen as a threat by them. Banks would now need to offer more perks and incentives to the credit cardholders in order to retain their loyalty.

Additionally, the age of consumers is another reason behind China's rapid growth in mobile payment. According to UN reports, China has the second-largest youth population in the world with 328 million people between the age of 20 and 34. Many of these under−35 s, who grew up with smartphones and are very comfortable with the Internet and technology, have barely shopped apart from online. With the introduction of mobile payment, they were more than happy to switch their routine payment and adapted to the new technology quickly. This quick adaption by the youth, who make up 23% of China's population, vastly contributed to the rise of mobile payment. As they form a considerable part of the consumer market, they demanded mobile payment services from the early stages of its development and forced retailers, restaurants and other businesses to offer and adopt this payment terminal (Aldama, 2017). Hence, this technology rapidly became available in many stores and as the time went by; other people got to know of the advantages of such payment and

followed the early adopters. In other countries, although young shoppers do adjust to mobile payment quickly, they do not contribute much to its development, simply because of the low number of young shoppers there (Haider, 2017). The Japanese society, for example, has a high median age which means the demand for mobile payment created by young early adopters is relatively lower and less effective than in China (Haider, 2017). It is only reasonable to argue that young shoppers are a major force to spread and increase the use of mobile payment in any country and could be the differentiating factor between success and failure of this technology.

How Businesses Can Exploit Mobile Payment Method

Moving on, this paper explores ways in which businesses can exploit the aforementioned factors to utilise mobile payment in their core operations. As mentioned before, a major purpose of mobile payment is convenience for consumers (Aldama, 2017). So if this convenience is not provided to people, for any reason, they will stop using the method or will not even switch to it in the first place. An instance where convenience can be forgone is when people have to use multiple applications to pay for all their purchases since each application supports only a limited number of stores. Therefore, instead of asking every store owner what mobile payment application they support every time they shop, people will switch to credit cards or cash that can be used almost anywhere in the country. So if each major business creates its own application, people will have to use quite a number of applications simply because it is not feasible for a single business to get each and every store to support its application across the country. In order to achieve the purpose of mobile payment, businesses must eliminate this problem before offering their services.

The Need for an Integrated Application

An effective solution is to create an integrated payment terminal for all businesses. This integrated payment terminal will be the only application consumers need to pay for all their purchases in any store and can be created and operated by some of the biggest businesses with a significant market share in their industries. This collaboration, naturally, will then be followed by smaller companies as they will make use of this platform instead of setting up their own application. As a result, businesses will achieve the ultimate goal of mobile payment which is bringing more convenience to customers by ensuring there will be only one dominant payment application for people.

An integrated payment terminal also holds several advantages for businesses over the alternative of separate applications created by each company. Firstly, since operation will be on a much larger scale, all companies will benefit from economies of scale. Setting up data storing facilities, programming expenses, daily operations,

maintenance, etc., incur massive costs and saving up on these costs are material to companies. Secondly, they will have access to more resources and a bigger talent pool to execute this terminal which will reduce the chances of technical failures in the application and generally maximise the quality of the project. For example, it is much more feasible for a few companies to set the QR codes in all stores nationwide as opposed to only one company designing it. It is essential that a majority of stores support mobile payment from an early stage because if mobile payment cannot be accessed everywhere, customers will drop this payment method and switch back to cash or credit cards. Another benefit is that businesses obtain a more accurate purchasing pattern of customers since they receive data on all the products people buy using the integrated application. If there were several applications available, each company would only receive the data collected by the limited number of stores that support the company's application.

Infrastructural Needs for Mobile Payment

Furthermore, for the factor of inadequate infrastructure to support credit card transactions, in countries where payment by credit or debit cards is not common, an opportunity is presented for businesses to introduce mobile payment (Knowledge@Wharton, 2018). Similar to China, countries such as France, Russia and Germany have most transactions done by cash as debt payment through credit cards is not the norm (Aldama, 2017; Sullivan, 2018). Businesses can very easily bypass the "plastic card" stage and instantly invest in technologies and facilities to introduce mobile payment channels. The only other competition in these nations would be cash and as trend analysis has shown, people are moving away from cash transactions at a record rate worldwide. Hence, in this context, businesses could gain a massive advantage by implementing mobile payment where credit or debit cards are not the preferred option.

On the second level of analysis, in countries like USA, UK and Japan where infrastructure for credit card payment is already established, businesses will find it tougher to penetrate the market by bringing in mobile payment (Smith, 2017; Van Hoek, 2017). However, this is by no means an impossible task as credit cards still do present some drawbacks. Some of these include the tendency to overspend and blow one's budget, high interest rates and increased debt, as well as risks of credit card fraud, all of which make people feel a little edgy using this as a primary medium of payment. Also, in a lot of countries, usually only cash and credit cards dominate the market; hence, people are constrained by the choices they can make. More often than not, people simply do not know that there are other payment options out there and are simply content with what is offered to them now. This is where businesses can step in and facilitate mobile payment to offer another option for consumers to choose from. As discussed earlier, mobile payment brings with it heaps of benefits, so in countries where credit card is seemingly popular, it should not deter businesses

from introducing an alternative, more advantageous form of payment using mobile devices; a factor they can leverage on.

Among the initiatives businesses take up include making sure customers know they accept mobile payment. Even though mobile payment has risen in popularity, most customers would not know which business or company actually accepts this payment method. Hence, businesses must publicise the facility of mobile payment at its register and throughout its store, as well as specify the type of mobile payment it accepts so that it reaches the maximum number of target customers. Furthermore, businesses must have a persuasive sales pitch, known as an "elevator pitch" to accurately describe what exactly mobile payment is and how it helps people in their transactions, and these employees must be ready to respond to concerns raised by customers. This would significantly reduce the worry most people hold regarding its safety and security simply because they are unaware how this method works. Little do they know that mobile payment is actually more secure than plastic cards as payments are authorised by fingerprint scan and password and customer details are stored in a unique code (Aldama, 2017).

Besides, for the factor of age of consumers, businesses can employ several efforts in an attempt to woo the younger generation to ditch cash and card payment methods and embrace mobile payment. Some of the innovative technologies that can be implemented include creating loyalty programmes, managing mobile wallets, offering real-time offers and discounts and push notifications. Syncing mobile payment with a mobile device is a great benefit to customers as they no longer need to bring along their smartphones everywhere but can still accumulate reward points. Keeping track of rewards becomes easier for customers, and because of this, they are more likely to switch to mobile payment. Since the millennial generation is all about convenience and ease of use, businesses can certainly entice this target market through this effort. Beyond this, businesses can look into the option of developing a special, mobile-only reward system and only offer certain promos on mobile devices. Additionally, businesses can utilise push notifications, whereby messages and updates pop up on a customer's smartphone and these messages may include real-time promos, discounts and deals that will be greatly appreciated by these customers. The plus point about push notifications is that it will appear even when the customer is no longer on that application and the smartphone could be idle; thus, this ensures all messages will be communicated to customers as they will never miss it. Understanding that the younger generation now enjoys customisation and personalisation, businesses can provide certain promotions to targeted customers based on data collected regarding their location, purchasing history and preferences. Not to forget, with the rise in wearable technology that supports near-field communication (NFC), more customers will rely less only on their smartphones for payments but will look to bracelet-like smartwatches to complete transactions — a development that businesses and organisations must pay special attention to.

Risks and Recommendations

The focus of attention is now on the risks to businesses if they adopt said technology postulated above. The issue of paramount concern regarding mobile payment is certainly security (Rampton, 2016). Deep-rooted fears of having your data stolen are one of the barriers of entry that businesses face when introducing mobile payment to their business model (Rampton, 2016). Data theft is not only a risk to the consumer but also to the company as well. In order to support a seamless mobile payment experience, a huge database of user information has to be in place. The sheer volume of user information such as bank details is invaluable and a potential target for criminal hackers (Rampton, 2016). Case in point, in April 2011, Sony Corporation confirmed that their PlayStation Network service was a victim of data theft whereby 77 million user accounts were compromised as their information was stolen. Sony was faced with many civil lawsuits for failing to take the necessary steps to protect its customer data Experts estimate that Sony lost approximately $170 million in legal fees and other costs incurred in trying to reclaim its customers' faith.

Accepting mobile payment also means that you are accepting a plausible can of worms that it may come with such as fraud (Van Hoek, 2017). As mobile payment gains traction and popularity, the interest shown by criminals too increases in tandem as it presents an opportunity and a loophole they can exploit to gain profit (Van Hoek, 2017). The Mobile Payment Security Study conducted in 2015 by ISACA Information Systems Audit and Control Association (ISACA) stated that mobile payment users are susceptible to the privacy loss and data theft through use of an actual mobile device, public wi-fi and due to "phishing schemes" attempts to steal valuable information by disguising as a credible person on the Internet. Also, friction in ideologies between different age groups could also bring the mobile payment dream to a screeching halt (The Economist, 2016). Tencent has been trying to bring WeChat Pay to Japan since 2016 but it has not been able to gain any sizeable following (Cheng, 2017). This could be attributed to Japan's ageing population that still overwhelmingly prefers the traditional method of cash payment (Haider, 2017). This showcases the risk that older demography may pose a greater resistance and have a more difficult time adjusting to mobile payment. After all, human beings are a creature of habit, and deep-rooted habits can be hard to alter.

The risk of loyalty programmes is that it does not guarantee repeat customers because only high-quality products and services that add value will incentivize customers to return to a particular business. Offers and discounts often only serve as short-term motivating factors, rather than definite factors to keep customers. Also, to ensure customer needs and preferences are always updated, businesses must constantly invest in up-to-date technologies and computers and have a data-driven strategy that links transaction and customer data. All of these require significant monetary outflow and a competent workforce that is technology-adept. However, the biggest risk of entirely focusing on the younger generation is that businesses might be too myopic in targeting only one specific target market. All these technology initiatives cater primarily to young adults and as mentioned earlier, they make up only 23% of

the population; thus, businesses face the risk of isolating a significant chunk of society that is not skilled at technology and therefore will not take up mobile payment. This is especially problematic in nations like Japan and Italy where the proportion of citizens over the age of 65 is 26.33% and 22.4%, respectively (Haider, 2017). There is also the uncertainty that not all millennials will be open to the concept of mobile payment, and there might be some who still find embracing technology to be a challenge. This could lead to disastrous consequences as businesses might end up investing so much of time, effort and money into setting up state-of-the-art infrastructure to support mobile payment only to find that the older generation simply cannot comprehend this technology and the younger generation still skeptical about this idea. This risk, known as strategic risk, happens due to poor business decisions and could threaten the entire existence of a business.

Conclusion

While the benefits of mobile payment have clearly paved the way for Alibaba to make immense profits in a brief period, the company is also exposed to the high degree of risks that an endeavour of this scale presents. In order to combat or mitigate these risks, the company has taken a number of informed steps in order to maximise its benefits to the company while minimising the risks it brings. China's shortcoming in supporting credit cards has been a blessing in disguise as Tencent and Alibaba were able to use it as a launching pad to propel mobile payment forward in the country (Cheng, 2017; Knowledge@Wharton, 2018). If that isn't enough, the social demography of China, which has a higher composition of young people prioritising convenience at every step of the way, is another deciding element that has solidified the position of mobile payment in the Chinese market (Cheng, 2017). If businesses were to take advantage of mobile payment, they would need to collaborate and come together under one umbrella to avoid inconvenience and unnecessary clutter to consumers. No user wants to install 10 different applications for the purpose of payment. Having only one application also allows businesses to take advantage of pull media and push notification to further capitalise on the millennial market. However, it is important for businesses to understand that mobile payment comes with its own set of problems, most notably, data theft, fraud and invasion of privacy (Rampton, 2016). Fortunately, most of the issues associated with mobile payment can be easily solved as technology progresses and with mobile payment getting the recognition and traction it deserves globally, businesses will be more willing to pump more funds into research and development to ensure it is more secure and reliable.

In conclusion, cash has been king for a considerable amount of time. The fact that we are still relying on a method of payment that was developed in the seventh century is mind-boggling to say the least. Each year, government-owned banks spend an inordinate amount of money trying to replace paper notes that are damaged from daily wear and use. Mobile payment provides an effortless solution to this age-old problem. This money can then be redirected to other more worthwhile pursuits

such as infrastructure development. Considering how unhygienic paper notes are and the inconvenience it brings to users, it is really perplexing that people are still apprehensive about the whole idea of embracing a cashless society. The thought of paying using a mobile device might have once felt like a scene from a cheesy 1980s sci-fi flick come to life but now, more people own smartphones, and it is quickly becoming a necessity rather than a luxury. While mobile payment was initially seen as something reserved for the tech-savvy early adopters in the Western world, that is no longer the case for both Kenya and China as it is the new norm for both businesses and customers in that part of the world (Currencycloud, 2015). In the past, conversations regarding mobile payment were inclined to revolve around the idea of functionality, security and cost but as Alibaba and Tencent have shown the solution to these three key pillars for customer adoption, only one question remains: What is next?

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Manroshan Singh Bhatt is a final year undergraduate at University of Malaya, pursuing a Bachelor of Accounting. In addition, he is currently undertaking the Association of Chartered Certified Accountants (ACCA) professional qualification, due for affiliate membership in 2019. At the university level, he has excelled in both academic and non-academic endeavours. Being a university debater, he has participated in reputed competitions both at a national and international level and has had several accomplishments including Champion of the 2017 UCSI-UPSA Inter-University Debating Championship, semi-finalist of the 2018 Australasian Intervarsity Debating Championship (ESL Category), and a two-time octo-finalist of the Malaysian National Intervarsity Debating Championship. He has also found success in strategy development and risk management-themed competitions. Along with the co-authors, he was the national champion of Deloitte Risk Intelligence Challenge 2018, in which he received the Best Speaker Award and semi-finalist of HSBC Malaysia Business Case Competition 2019. His aptitude for finance is also proven, being part of the University of Malaya team that emerged runners-up of MFPC Malaysian Financial Planning Competition 2018. In the long-run, he sees himself in the field of advisory/consulting, specifically dealing with strategy development and operations.

Muhammad Arief Siddiq Md Daud is a third-year accounting student at University of Malaya. In 2018, he won the Deloitte Risk Intelligence Challenge Malaysia in which the preliminary question forms the basis of this paper. He was also the recipient of the Risk Identification Award at the ASEAN Deloitte Risk Intelligence Challenge 2018. His other accomplishments include EY Young Tax Professional of the Year 2018 finalist, CIMB 3D Journey 2018 country finalist and HSBC Business Case Competition 2019 semi-finalist. He is also currently engaged as a Deloitte Student Ambassador for University of Malaya.

Reza Aminosharei is an undergraduate accounting student at University of Malaya and is due to become an affiliate of the Association of Chartered Certified Accountants (ACCA) in 2019. He was the champion of Deloitte Risk Intelligence Challenge Malaysia for two consecutive years, 2017 and 2018. He was also the winner of the Risk Identification Award at the ASEAN Deloitte Risk Intelligence Challenge 2018. He was also the semi-finalist of HSBC Business Case Competition 2019 in Malaysia. He is currently employed in KPMG Malaysia in the audit department.

Kim Mun Wong is a final year Bachelor of Accounting student from University of Malaya. He is also concurrently pursuing his ACCA professional qualification. His main areas of interest are tax, corporate finance, internal audit and strategic management. He was actively involved in organising and participating in academic competitions and non-academic-based programmes throughout his studies. In 2017, he was awarded the Deloitte Book Prize Award for obtaining the highest score in the Individual Income Tax examination. He was awarded the Academic Award at the 2017 Fourth

Residential College Annual Dinner for his academic and co-curricular achievements. He has represented the University of Malaya in numerous academic competitions. In 2018, he was among the winning team members of the Deloitte Risk Intelligence Challenge and represented Malaysia at the ASEAN level. He also emerged as the runner-up in the PNB Investment Quiz Challenge in the same year. Recently, he participated and reached the semi-finals stage of the HSBC Malaysia Case Study Competition 2019.