

Enterprise Risk Management in Malaysia: A Case Study

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ABSTRACT

Purpose: This study identifies the role of internal control system in good risk management practice with reference to Sarbanes-Oxley (SOX) Act or equivalent Japan-SOX (J-SOX) or Malaysian Code on Corporate Governance, MCGG. **Methodology:** This case study focuses on a multinational corporation (MNC) hosted in Malaysia. The enterprise's risk management practices to be analyzed. **Findings:** It was found that the successful implementation of ERM relies on corporate governance, especially periodic monitoring. **Originality:** This study contributes to the literature as an in-depth study providing practical insights in terms of implementation of enterprise risk management in the industry on importance of internal auditing in managing risk.

Keywords: enterprise risk management, Malaysian code on corporate governance, multinational corporation, risk management process, sarbanes-oxley act.

1.0 INTRODUCTION

According to the Ministry of International Trade and Industry (MITI), Malaysia is ranked among the top 30 largest trading nations in the world, having regional Free Trade Agreement (FTA) as an Association of Southeast Asia Nations (ASEAN) member with China, India, Japan, South Korea, Australia and New Zealand, and bilateral FTA with Australia, Chile, India, Japan, Pakistan and New Zealand. Therefore, Malaysian firms are competing with other countries in the global level playing field. Malaysia's economy growth fuels international investments drive to establish in this emerging economy. MNCs establish operations in Malaysia so as not to fall behind competition. Effective financial risk in a multinational corporation (MNC) is critical for the growth in the globalization era. MNCs need to balance the attention of the stakeholders who want to have a good control and other stakeholders who want to get more information that supports them in making investment decisions.

Agency theory is an analytic expression of the contractual relationship of two or more parties, in which one party, designated as the principal, engages another party, designated as the agent, to perform some form of services on behalf of the principal (Jensen & Meckling 1976). The agency theory is, however, related to the fact that enterprise risk management (ERM) can help an organisation to achieve its business objectives and ultimately maximize shareholders' value (Bowen *et al*, 2006; Nocco & Stulz, 2006). In other words, the cost of each agency will be reduced because of higher performance of firms (Uadiale, 2010).

ERM can align with the business assumptions and proactively help in overcoming the possibilities of the business failures (Gupta, 2011). Foreseeable threats can result to problems and crises; while, achievable opportunities can mislead to loss of benefits (Hillson and Murray-Webster, 2007). Specifically, past studies, for instance, Leinberg (2006, 2008), Razali, Yazid and Tahir (2011) and Bertinetti, Cavezzali and Gardenal (2013) found positive relations between the ERM adoption and firm value. Nickmanesh, *et al.* (2011) recommended that effective risk management strategy would influence performance of firm new-product development. Kanani *et al.* (2013) portrayed risk management and sustainable growth as a signaling perspective to investors. According to Rodrigues and Raposo (2011), firms that have a high entrepreneurial orientation (EO) have a superior performance. Overall, literatures such as Pagach and Warr (2011) indicated that firms adopted ERM were motivated by economic benefits; Hoyt and Liebenberg (2011) found a positive relation between ERM adoption and performance reflected by organisational value; Gates, Nicolas, and Walker (2012) found ERM resulted in organisational value both enhanced management and improved organisational performance, and Vasile, Croitoru and Mitran (2012) suggested that effective risk management process would increase the business performance and overall performance. ERM is defined as an integrated framework for managing credit risk, market risk, operational risk, economic capital, and risk transfer in order to maximize the firm value (Lam, 1999). According to McShane, Nair and Rustambekov (2011), ERM is the integrated management all risks of organisation which can create organisation's value better than manages risk independently. Corporate governance comprises multiple control levels emanating from the accountability relationships at the board, management and operational levels (Christopher, 2010).

Operational risk is the loss due to any disruption in the firm's processes; and global operation, emergent of more complex products and services, the increased in volumes and volatility of transactions lead to greater operational risk (Marshall, 2001). Marshall (2001) elaborated further that strategic business planning and well-organized budgeting process and consistent follow-up with any operating variances to budget can limit unexpected losses. Risk management is quite a broad concept. Risk management aims to provide an efficient system in order to improve

performance, meeting different market conditions and government regulations. Therefore, it is crucial to maintain risk management when keeping a record in the organisations. Risk management and internal control are regarded as parts of corporate governance. Though in the past, very few organisations find ERM implementation easy – it requires a rare combination of organisational consensus, strong executive management and an appreciation for various program sensitivities (Negus, 2010).

On the other hand, ERM also provides a significant source of competitive advantage for those who can demonstrate a strong ERM capability and strength (Stoh, 2005). In a study to examine the factors associated with the adoption of Enterprise Risk Management (ERM) among public listed companies in Malaysia, the results showed that only 43 percent of the companies had adopted ERM completely and the others implemented partially (Daud, 2011). On the other hand, Lai and Samad (2010) obtained encouraging results indicating ERM program implementation in ‘good’, i.e. the average mean score of 3.82 on the 5-point Likert’s scale among public listed companies in Malaysia. Particularly, ERM implementation was found more common in the infrastructure, hotel, and technology sectors (Soltanizadeh, *et al.*, 2014). Hillson and Murray-Webster (2007) argued that the most significant critical success factor for ERM was ‘an appropriate and mature risk culture’.

The purpose of this paper is also to evaluate the implementation of risk management, and to provide information on its applications. This paper aims to obtain a better understanding of how a MNC can utilize risk management and internal control for surviving and performance development. The paper is intended to study an internal control system with effective risk management practices. The focus of this study is risk management and internal control of an electronics components manufacturing MNC in a case study. The paper also specifies the geographic area, Malaysia. The study employs internal control as the instrument to manage firm’s risk. The study focuses on how the internal control and risk management strategy be applied in a MNC.

2.0 LITERATURE REVIEW

2.1. The Perspective of Internal Control

The financial crisis of 1997/1998 had highlighted various instances of internal control failures that resulted in significant cost to shareholders, raising issues of the quality of risk management practiced by Malaysian corporations (Gaikwad, 2008). The collapse of Enron in 2001 and the revelation that besides audit fee, Arthur Andersen earned for consulting, thus raising questions about conflict of interest.

As a result, Sarbanes-Oxley (SOX) Act was passed in 2002, and it requires management making representations about the effectiveness of its internal control structure (Tackett, Wolf and Claypool, 2004). The legislation set standards for all U.S. public company boards, management and public accounting firms, and it gradually become the standard and guidance. In light of the stock market events of 2008 and economic recession, results of the study by Fafatas (2010) suggested that audit firms implicated in bank failures, Fannie Mae and New Century, are likely to react by enforcing more conservative accounting standards. The impact of the global financial crisis has highlighted the importance of risk management (Coskun, 2012) and revealed substantial weakness in risk management practices (Paape and Spekle, 2012). One of the previous studies, Rogov (2006) proposed to apply the tool of financial mathematical apparatus of beta and alpha analysis of financial assets (CAPM, etc.) based on global risk factors.

The Star reported that the Malaysia equivalent is Malaysian Code on Corporate Governance (MCCG 2012) which supersedes Malaysian Code on Corporate Governance 2007 (New governance code stresses board effectiveness, 30 March 2012). Among others, Corporate Governance Blueprint 2011 stated that the Board should ensure women participation on board to reach thirty per centum (30%) by year 2016. Listed companies should comply with the Principles of MCCG 2012 including the Board Gender Diversity Policy. These legal requirements mandate quality and consistency in internal controls, information access, work flows, processes and disclosures.

Several events indicate absent from quality internal control in companies like Transmile, Linear and Kenmark. In 2005, Transmile's auditors were unable to obtain the supporting documents from to satisfy itself as to the fairness of the trade receivables and related sales, and there were no documents to support payments made for the purported purchase of property, plant and equipment. Furthermore, the investigation revealed that CEN Worldwide Sdn Bhd (CEN) continued to be given credit although it owed Transmile millions in unpaid debts (Rahman and Salim, 2010; p99). Executive director of Transmile was convicted for his role in Transmile's fraudulent transactions (Nazlina, 2011). In the case of Linear, it was discovered by the special auditor appointed that its financial statements from 1999 to 2008 were overstated as Linear's announcements of sales of solar-energy panels and cooling tower parts to foreign corporations could not be proven and there was also no proof of the (billion ringgit) King Dome project (Tee, 2011). In May 2010, letters of demand were issued to Kenmark but its managing director together with the other executive directors were not contactable for a week; and the managing director later engineered active trading of the shares, finally disappeared once he had divested himself of most of his shares (Goh, 2010). Following the revelation of the questionable financial affairs of Silver Bird Group Bhd, resources were prioritised to investigate the matter promptly. The SC's

investigation culminated in criminal charges being preferred against two of the company's directors for the reporting of false revenue (SC, 2013). The charging of two former directors of Silver Bird Group Bhd, were slapped with 134 counts of cheating a bank of RM67.4 million on 10 December 2012. They were sued for alleged breach of fiduciary duties, breach of duty of fidelity and loyalty, abuse of power, conspiracy to commit fraud and for facilitating misappropriation of funds under Section 420 of the Penal Code (Tan & Loo, 2012).

Recently, the external auditor of Ire-Tex Corp Bhd has expressed a qualified opinion on the Zoomic Automation's financial statements for the year ended Dec 31, 2014. The auditors UHY said the basis for its qualified opinion was due to trade receivables from sales, which were then impaired as of Ire-Tex's financial year end. The auditors also drew attention to its agreement with a supplier to purchase machinery worth RM16.5mil. Subsequently, Ire-Tex entered an agreement with a separate supplier to revamp and upgrade the existing machines for RM16mil. It made RM1mil advanced payment to the supplier (Wong, 2015).

2.2. Perspective of Risk Management

Risk definitions, goals and methods vary widely according to whether the risk management method is in the context of which industries, which may cover project management, security, engineering, industrial processes, financial portfolios, actuarial assessments, environment or occupational health and safety. Risk management as a separate field for research concern for the environment and human health. Founders of Society for Risk Analysis (SRA), founded in August 1980 were primarily interested in the impact of chemical risk to human health (Thompson, 2005). The development of project risk management emerged in the energy sector in mid 1970s, included BP's North Sea projects and pipeline in North America. From mid 1980s until early this century, the project risk management focused on finding the common structures for all the projects and identifying different approaches needed for each project (Ward and Chapman, 2003). Not only the largest companies have been influenced by risk management, but small firms have also been affected; relatively, small companies do not feature a great deal of systematic risk management (Simu, 2007). The power relations have been reflected by corporate governance, which exist among shareholders, management, labor and creditors (Jackson, 2001). Hence, risk management is crucial as risk is central / essential corporate governance (Spira & Page, 2003; Lai & Samad, 2010).

Nevertheless, The New Straits Times reported that Malaysia had strengthened its regional standing in corporate governance after recording higher scores in the biennial Corporate Governance Watch 2014 Report (CG Watch) by the Asian Corporate Governance Association in collaboration with Credit Lyonnais

Securities Asia (ACGA-CLSA) Asia-Pacific Markets; Malaysia achieved an overall score of 58 per cent in 2014 compared with 49 per cent in 2007, maintaining its fourth ranking in the region. Especially, Malaysia was also recognised for its strength in financial reporting and auditing standards ranking equally first with Singapore. Reported by the New Straits Times, areas of consistent improvements shown by Malaysia include corporate governance culture, rules and practices, enforcement, accounting and auditing (Malaysia scores higher in CG Watch, 15 October 2014).

On the other hand, Kolk (2008) reported that companies from US, Japan and Europe seemed to be dealing with corporate governance in different ways, that Japanese companies deserved specific attention regarding complaints mechanisms and structuring of sustainability.

2.3. Applying Risk Management

Risk management is the method to control the results with certainty. Uncertainty represents that something is not able to be relied on, or unknown or indefinite. Risk, however, is only related to the negative results which are not able to be controlled uncertainty that may cause the catastrophe or loss of all kinds of interest such as money, etc. (Li & Nadeem, 2010) The main purpose of risk management for a manager is to avoid contractual, tortuous or statutory liability (Ashby and Diacon, 1996). They found that the drivers for using risk management are primarily negative, and the aim is to avoid risk outbreaks. They also found that companies have not set their common risk management objectives. There were no associations between the risk management and firm's financial characteristics or operating behavior.

2.4. The Audit Approach

Rajeswari and Hemaloshinee (2014) recommended that government to monitor the audit committee functions that the directors of Audit Committee are financial literate for effectiveness of Audit Committee function. Shafie, *et al.* (2009) found that longer audit tenure has positive significant association with an auditor's reporting decision; if a client never changed its auditor since listed in Bursa Malaysia, there would be a tendency to issue a clean opinion. There are two risk-based audit methodologies, which are "bottom up" audit and "top down" audit. In 2001, KPMG's brochure explained the difference between the two methodologies. According to the traditional "bottom up" audit, "the auditor gains assurance by examining all the components of the financial statements, ensuring that the transactions recorded are complete and accurate." Whereas, the "top down" risk-based audit may concentrate on "less on the details of individual transaction".

Auditors should use their knowledge of the client's business "to identify risks that could affect the financial statements and to target audit effort in those areas." That is, more numbers that spit out by the client's computers will be used by the auditors (Weil, 2004).

Furthermore, auditors must adhere to a strict professional code of conduct in order to maintain the confidence of the shareholders and stakeholders (Krishnan, 2009). Paape and Spekle (2012) advocated quality audit firms were more likely to encourage their clients to improve the level of their enterprise risk management (ERM) practices. Geiger *et al.* (2005) reported that the Enron bankruptcy, Big 4 auditors were more likely to issue qualified going-concern opinions on financially distressed firms. Nevertheless, accounting research relies on *ex-post* indicators to identify the occurrence of an audit failure because direct evidence of audit quality is not typically observable by that outside of the accounting firm (Fafatas, 2010), and examples of such indicators include lawsuits against auditors (Francis, 2004).

2.5. Non-Financial Risk Factors

By the 1990s, the failure of operating non-financial risks has been discussed a lot as one of the reasons that influence businesses (Bergin, 1998). Egbuji (1999) studied that businesses are constantly faced with the need to manage change within their organization, and the change generates choice, which carries risks where a range of issues are to be addressed in risk management of organizational records. This researcher concluded that for risk management of organizational records to be effective, it needs to be incorporated into the decision-making process of the organization making it central to all activities, and the most effective way to have risk management central to an organization is to make the process integral to the organization's decision-making process. Furthermore, a clear policy statement from management supporting the risk management activity is important in order to safeguard the necessary cooperation from departments, especially when attempting to implement protective measures for records and information.

3.0 METHODOLOGY

This study found that qualitative research method would be more suitable for the study, aiming to provide a comprehensive description of an internal management control system with an emphasis of reporting system and information technology entrepreneurship risk management. The research strategy of this study is the case study of a MNC hosted by Malaysia. Using a single case study, the paper will report the findings using the chosen company as well as providing an opportunity to analyze and to achieve research objectives. In this study, the data collection sources are the Company related issued research literatures.

4.0 CASE STUDY

4.1 Risk Management Process

Risk assessment involves risk identification, risk analysis and risk evaluation. The business continuity management (BCM) assessment is a checklist asks on preparedness against unwanted events cover emergency pack, building facilities, personnel, security, paper & electronic documents, equipment, information technology, suppliers, customers, location and insurance and given BCM score. Risk associated with any decision should be identified and should place in a risk register before they can be treated, even if it is later determined that the risk levels with existing controls are acceptable. Risk identification will help stakeholders relate to risk and have potential to improve the effectiveness of control. Risk analysis is to provide the decision maker with sufficient understanding of risk. The Business Impact Form was used to analysis the impact of risk to the business. Risk analysis organizes into the estimates of likelihood of events, estimates of consequences of events and estimate of the combined effect of likelihood and consequences according to the risk criteria. Each risk after analysis is evaluated by comparing the residual risk after risk treatment against the risk criteria. The items of the risk assessment format are: category, event, probability (possibility), severity (amount of loss), severity (period of recovery), severity (possibility of business continuity), severity (loss of credibility), total impact, risk rating, risk priority, mitigation and further measure.

The list of risk assessment evaluates based on the qualitative risk analysis matrix and quantitative risk performance. For the case study company, there were nine events from five categories in human disaster, environmental accident, material, tool and information system evaluated as extreme risk level that required immediate action. Even though existing mitigation already in place, further measures possible were still required. The consequence's level is explained as follows:

Table 1: Consequences level

1 ~ 5	Low risk; manage by routine procedures
5 ~ 7	Moderate risk; management responsibility must be specified
8 ~ 10	High risk; senior management attention needed
11 ~ 20	Extreme risk; immediate action required

Risks associated with controls, and implementations are should be considered in risk evaluation and risk analysis. Among the activities of risk treatment includes the identification of control options, selection of control option and its implementation. The sample of an improvement plan matrix as follows: capability,

observation title, recommendation, CAR description, capability element, primary responsible, agency PIC, start date and completion date.

Monitoring and review are two activities along with risk communication and consultation, which are applied to the activities of context, assessment, and treatment, i.e. the continuous improvement of the risk management process. As risk is uncertainty about effects on the business activities and objective, there is a strong incentive to invite stakeholders for communication and consultation in order to ensure the accuracy and effectiveness of the risk management process, so that to promote extensive communication among team members and consultations with other experts in the organization. Risk management activities should be recorded and standard policy for any important activities in organization. Information systems are used for record keeping, protection, storage, retrieval and disposal need to be designed, monitored and reviewed based on ISO 27001 Information Security Management System (ISMS). According to Schieg (2006), risk management can therefore only be implemented and enforced effectively if communication channels are created. It would be more beneficial to organizations should they implement information governance as it ensures records and knowledge are systemically managed for the sustainability of the organizations (Isa & Nordin, 2012).

4.2 Implementation of ERM Framework

The Business Continuation Management (BCM) Manual is the basic guidance for business continuity. When needed, a Crisis Management Committee (CMC) has the business continuation plan invocation and disaster activation authority, consists of a group of senior management personnel who will manage the situation from start to finish and provide the necessary support to the working teams will be established. An emergency contact network is also established to ensure smooth decision making and implementation in case of emergencies. The Company formulated continuity strategies and plans, developed response, implemented the plan, regularly test, review and audit the plan.

The Company maximizes the organization's human resources through effective work allocation based on their knowledge, skills and abilities. The Company engages the IT personnel to conduct information security management system (ISMS) programs. The Company also shares best practices of awareness training with the internal control department of its parent company. To achieve effective control, the Company recognized key indicators for managing market, credit operational as well as non-quantifiable risks (political and legal) and set appropriate risk level for each indicator. Crucial processes especially plant-wide ones were documented as part of standard operation procedures (SOPs). Employees given opportunity to suggest ideas that would improve work processes. Furthermore, employees are also regularly tested on their understanding of company policies.

The non-quantifiable risk factors are also essential to be considered while making decision that would affect financial information and risk management. The non-quantify and external factors include political, social, legal, informatics, environmental, technical, economic, and even nation security. For instance, the latter will be affected by the Malaysia's Strategic Trade Act, equivalent to Japan's Security Export Control or United States' Export Control Regulation when exports of strategic items need to have export permits. Another legislation includes Employment Act 1967, Industrial Relation Act 1967, Employees' Social Security Act 1969, Factories and Machinery Act 1967, Occupational Safety and Health Act 1994, Personal Data Protection Act 2010 and Environment Quality Act 1974. The Company shares best practices with an internal control department of its parent company.

It is important to build well-controlled procedures so that the whole organization's risk management procedures are under supervision, and as fraud risk prevention program. All of its activities should be divided as authorization, approval, and implementation, record and monitoring. If a manager has mandated right, he is not suggested to execute the activity. According to the principle of control activity, he should not inspect and supervise the same business activities. Generally, in the company, in addition to report its financial statements to company managers, they also report to the board of directors as well as HQ in order to ensure the implementation of internal controls. Internal auditing provides assurance to boards of directors on managing risk (Sarens *et al.*, 2009). The Company has also promoted a third-party run global help line which also observed the whistle-blower policy, and it was expected to minimize employee's intention to commit fraud. Consequently, it is understood that implementation of ERM framework is much more important than planning.

4.3 Information Technology and Risk Management

In MNCs, the information system may continually be updated, and the software applications will be replaced with newer versions. Furthermore, it is possible happened that personnel and information technology security policies changes over time. These changes may bring new risks. Therefore, it is emphasized that good practice in MNC which needs continuing risk assessment and evaluation will result in a successful risk management process. IT governance and control standard, Control Objectives for Information and related Technology (CoBIT) is now more stringent that ensures the quality and consistency of the compliance programmes, information work flows, and disclosures. The most important point is how to apply information technology policy and governance model into the existing organization structure and integrated IT systems, since it is industry best practices and supports the organization's business objectives. The functions of information systems are to identify, capture, process, and on time distribute

relevant information. Hence, classifying and protecting sensitive data are extremely important to the business. An appointed external information security auditor reports to the board and the parent company directly. The IT audit documents required checklist that covers data centre & network operations, access security and programme change & application maintenance. Any improvement required will be reported in a general IT controls management letter point sent to the global headquarters.

It was observed that a successful risk management process in the MNC needs: (a) the commitment from senior management. The top management must ensure that accurate records are kept, and they realize that is their responsibility, (b) The effective support and participation of the IT team. For example, the server room had been monitored under 24-hours surveillance via an instant alert system by the IT team where emergency situations at the server room could be detected within a very short duration. Hence, any loss would be controlled to a limited extent. This is similar to conclusion of the study of Schieg (2006) that effective risk management requires commitment and the risk conscious behaviour of each individual in an organization. (c) The ability of the IT team, which has the expertise to apply the risk assessment way to manage the information system (business operations and revenue streams), identify mission risks as well as provide cost-effective requirements that meet the needs of the Company. They also document the management configuration and version control. System compliance wise, they ensure Anti-Virus compliance on a regular basis, all Privilege (Super-user) accounts being managed and control in well manner, system patch constantly reviewed and documented with standards, and systems being back up on regular basis mitigating system failure, including yearly testing, and (d) to know and cooperate with the end-users. In practice, the information owners record the requirements for business and information security. And access to sensitive data and network is password protected subjected to renewal administration. Even though a cautious and complicated risk management system may not a guarantee of excellent results, this set of clear rules of the game assure the Company's culpability at least, which will generate more consistent returns in return. The well-established management structure, reporting system, adequate corporate governance, and effective internal control will protect the MNC from the risk.

5.0 CONCLUSION

This case study presents the relationship between the enterprise risk management and internal audit implementation at a MNC. The case study gave insights that for a business to sustain, companies must effectively practice risk management, and risk management must be fully integrated with all business processes of the enterprise. Proper management reporting system, ERM framework, enterprise

resource planning (ERP) system and implementation of good governance principles have helped the Company to control the internal and external risks. For risk management to achieve its objectives, all employees in the organization should understand that the responsibility for managing risk is not specific to a group of staffs such as Corporate Department or IT Department of the organization only. Everyone in the organization should be properly guided to comply with the risk management procedures. Periodic monitoring of the reporting system will result in better risk control. The case study provided useful insights for the role of internal auditing in managing risk within an integrated framework of accountability. Overall, the effectiveness of risk management practices will enhance the return on value to the stakeholders and thus encourage companies to continuously improve their risk management efforts.

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