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Research paper

The relevance of corporate governance practices for registered charity organizations in Malaysia

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Abstract

The aim of this study is to examine whether registered charities in Malaysia have implemented principle-based corporate governance practices similar to those implemented by publicly-listed companies in Malaysia. This study investigates the relevance of corporate governance practices represented by the Malaysian Code of Corporate Governance (MCCG) 2017 on the financial performance of the registered charity organizations as measured by the program efficiency ratio. Panel data for the registered charities over the period 2014-2016 are analyzed using Ordinary Least Squares (OLS) regression. Program efficiency ratio is used as the dependent variable. The results confirm that board size, inclusion of outside directors and volunteers, as well as the presence of large donors in the board are positive and significant. Both organizational size and age are also important as performance determinants. Attention should be given when interpreting and generalizing the results due to the small sample size used, as compared to the whole population, which may have had a bearing on the results. This study offers insights for policy makers and regulators interested in adopting corporate governance practices for the charity organizations within Malaysia.

Keywords: *Charity Organizations; Corporate Governance Practices; Performance; Program Efficiency.*

1. Introduction

Non-profit organizations (NPOs) or non-governmental organizations (NGOs) play an important role in the Malaysian community. In order to strengthen the role of NPOs, the government has increased the provision for NGOs to RM160 million in 2016 from RM50 million in the 2015 Malaysian budget. It aims to help organizations implement programs based on community development, solidarity, social welfare, health and safety. Given the huge amount of provision by the government to NPOs, it is necessary to monitor how charity organizations practice their governance to ensure that charities meet the legitimate expectations of their stakeholders. Indeed scandals of some major NPOs have spoiled the public trust and show the need to have effective governance practices for NPOs to fulfil their duties towards their organizations. The adoption of effective governance practice in corporate and government sectors have served its purpose to enhance accountability, legitimacy and transparency. As there is no guidance or standard on non-profit governance practices in Malaysia, it is therefore feasible that this study examine whether the registered charity in Malaysia have implemented the principle-based corporate governance practices similar to those implemented by the public-listed companies in Malaysia.

Charity organizations depend on funds from various sources, including donations, membership fees, government grants as well as commercial activities for their continuity. These vast amount of resources should be efficiently utilized to align with their organization purpose.

Poor risk management practices, failure in monitoring, lack of internal and external control and dishonesty-related problems indicate that the management and the processes in charity organizations need to be improved (Abraham, 2007), and this has increased the demands for greater transparency and accountability (Edwards & Hulme, 1996). Thus, the adoption of best governance practices has been highlighted as one of the important keys to avoid future failures. Newbury (1992, 1994) suggested the increase of government regulation for NPOs such as the introduction of an operating procedure as an option to demonstrate greater accountability.

Although substantial failures have not occurred in the charity sector, there should be concerns of the accountability and transparency of charity organizations (Reddy, Locke & Fauzi, 2013). The lack of available information to the public, particularly with regards to the financial information of these charity organizations, further exacerbate the concern of the management in terms of how donated funds received from the donors are utilized (Saunah et al. 2013, 2014). Furthermore, the increased occurence of dishonesty-related problems in charity organizations as a result of dominant executives influencing trustees (Baskerville, 2006; Martyn & Gousmett, 2011) is also of much concern. This indicates that the managing and controling processes still need to be improved to demonstrate transparency and accountability of the funds they received from stakeholders (Abraham, 2007). In addition, Newbury (1992, 1994), emphasizes the need for self-regulation by the charity organizations i.e. the need to have a standard or best practices of effective governance practices as a guidance in running their organizations, such as practiced in New Zealand.

In Malaysia, there is no regulatory body till date to monitor the compliance of the charity organizations. There are two (2) main authorities of NPOs in Malaysia, the Registry of Society Malaysia

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(ROS) and the Companies Commission of Malaysia (CCM). These governing bodies monitor the activities of NPOs to ensure the operations of NPOs are in line with regulations such as Societies Act 1966 (Act 355), Societies Regulation 1984, Income Tax Act of 1967, Anti-Money Laundering Act of 2001 and Anti-Corruption Act of 1971. According to the Societies Act 1966 (Act 335) & Societies Regulations 1984, societies consist of seven members or more, with specific purposes, excluding companies, trade unions, cooperatives and others. The Societies Act 1966 (Act 335) & Societies Regulations 1984 did not have any public requirement for financial reporting.

NPOs in Malaysia are in the form of charitable corporation (company limited by guarantee), society, youth societies or sports. NPOs with revenue of more than RM1 million can be registered as companies limited by guarantee (CLBG) with CCM whilst, for NPOs (societies) that earn revenue less than RM1 million, they are required to register under the Registry of Societies (ROS). The organizations can be classified as a charity irrespective of its legal form, provided it fulfills the definition of a charity organization as in Income Tax Act 1967. The institutions, organizations or funds established in Malaysia which are not operated or conducted primarily for profit may be considered for approval under subsection 44(6) of the Income Tax Act 1967. One of the criterias for approval under subsection 44(6) is that the organization must be established in Malaysia for charitable purposes only. Generally, the 'charitable' work consist of : (a) the relief of poverty; (b) the advancement of education; (c) the advancement of religion; (d) other purposes beneficial to the community [Para. 3.2, subsection 44(6), Income tax Act 1967].R OS and CCM advise the charity organizations regarding the registration of the organizations whereas the obligation for the income tax reliefs on the donations by the donors are retained by the Inland Revenue Department (IRD) under the Income Tax Act 1967. Overall, there are 56,762 societies registered with ROS as at July 2016. From the total number, 15,188 organizations were registered under the category of charity, being the largest category of NPOs, that represents 27% of the total NPOs in Malaysia. The ROS and CCM can perform their enforcement powers and impose administrative penalties such as warning notices for those organizations that failed to conduct their annual general meeting (AGM) and submit the annual returns that could result in the NPOs' deregistration. The rest of this paper is organized as follows: Section 2 presents the literature review, followed by Section 3 on research methods employed and Section 4 reports empirical findings while the final Section 5 provides conclusion.

2. Literature review

The main feature of NPOs is the principle of altruistic and voluntary acts. NPOs are generally value-based organizations which depend on charitable donations and voluntary services from donors or the public. A non-profit organization is not "owned", but is managed by individuals or other entities. These organizations are established to deliver mutual benefits to each of its members in terms of welfare and recognition, but not on profits.

Charity organizations need to adopt an approach to accountability whereby organizational response can be tactical or strategic. Without it, non-profit organizations might struggle to achieve their mission and tolive up to their values (ACEVO Consulting, 2011). In practice, governance has provided a vital link between NPOs and society, allowing people to place their trust in the organization, support its mission and ensure a continuing flow of resources to accomplish its mission (Trussel & Parsons, 2004). The presence of effective governance in NPOs can be accomplished by ensuring the behaviours of trustees are in place to attain its objectives.

The developments in the corporate sector have shaped wider expectations about governance that influence NPOs. This increases the likelihood that NPOs will comply with the regulatory requirements to best serve their multiple stakeholders. It is the responsibility of the board of trustees to ensure that their organization is accountable and transparent to stakeholders and the general public.

Of late, some NPOs have lost the public's trust and faced pressure to be more accountable and transparent to their stakeholders. Issues related to corporate governance such as poor risk management, inadequate internal controls and weak monitoring boards were identified as primary causes in organizations' failure. It could also be attributed to mistakes of the people who are not experts in managing how things are to be set up and structured, as well as dishonesty and corruption. This has led to discussions on appropriate policies among regulators and academician (Ostrower, 2007). Thus, developing "Best Practices" guidelines could be a yardstick for assessment on non-profit performance. According to Charity Governance Review 2013 by Grant Thornton, good governance practice is crucial as it facilitates NPOs to meet emerging challenges, as well as to curb self-interested managers' tendencies (Newton, 2013).

Reedy et al. (2013) suggests that better corporate governance practices applied in the charity organizations would result in lower risk and maximum utilization of their limited resources. Although there is no specific definition of corporate governance in the literature for the charity organizations, the principles outlined in the corporate governance could be adapted to the charity organizations.

3. Malaysian code on corporate governance

In Malaysia, the Securities Commission (SC) has a role in promoting good corporate governance practices especially among the public listed companies, through the implementation of Malaysian Code on Corporate Governance (MCCG) issued in 2000, 2007, 2012 and the latest 2017. The MCCG has outlined the principles and best practices of structures and processes towards achieving an optimal governance framework. In addition, Bursa Malaysia imposes mandatory requirements for Malaysian public listed companies to comply in tandem with MCCG. Tan Sri Zarinah Anwar, who is the former chairman of Securities Commissions Malaysia, suggested that the boards and the shareholders must have a wider comprehension that good business is not only measured by good financial position but also by upright ethical and sustainable position. The effort put by SC through the issuance of MCCGs ensures good corporate governance practices is applied by all public listed companies and enhancement of investors' confidence on the Malaysian capital market. Anheier (2005) argues that corporate governance is the system by which organizations are directed and controlled. One of the most important elements highlighted in any corporate governance practices is the credulity of the board. Charitable organizations are managed by the managers and monitored by the board of trustees from which the separation of the decision making role (managers) from the control role (trustees) leads to agency problems. The MCCG 2017 is based on three (3) key principles of good corporate governance, which are: (i) board leadership and effectiveness; (ii) effective audit and risk management; and (iii) integrity in corporate reporting and meaningful relationship with stakeholders.

A number of studieshave examined the relationship between board governance, particularly the board composition with the organizational performance (Callen et al., 2003; de Andres et al., 2005; Stone & Ostrower, 2007). Board composition may consist of board size, educational background, demographics (gender and age), remuneration and tenure. Findings related to board composition and the organizational performance are mixed. Some findings reported board composition is positively related to the organizational performance (Callen, et al., 2003; Guo, 2007) while others reports negative associations between board composition and organizational performance (Callen & Falk, 1993; Siciliano, 1996). It is argued that a larger board would facilitate a wider community representation by reducing the denomination of the CEO (Singh & Harianto, 1989) from which utilization of resources can be maximized. Thus, further empirical investigation is therefore needed.

H_1: Charity organizations with large boards composition are positively related with the performance.

Literatures on governing boards also address the effect of outside directors as a monitoring device. Although the presence of some insiders with a specific knowledge about the functioning of the organization for strategic decision-making is essential, outside directors provide a certain level of independence for monitoring managerial activity (Baysinger & Hoskisson, 1990). Thus, it is indeed important to further hypothesize that:

H_2: Charity organizations with outside director are positively related with the performance.

The charity organizations are governed by a volunteer board of trustees whose members are either elected or appointed according to the charity's governing document. The board has the highest responsibility in ensuring that the charity is governed and managed responsibly to ensure the effectiveness, credibility and sustainability of the charity. There are charities which all run their operations by volunteers providing their services for free. However, there is lack of studies conducted as to what extent these volunteers contribute to the performance of the organization. Reedy et al. (2013) hypothesized the presence of volunteers in boards with the performance and the result was found to be significant. In support of this positive relationship, hypothesis 3 is depicted as follows:

H_3: Charity organizations with volunteers are positively related with the performance.

Theoretical governance framework in NPOs provides support that large donors influence operational efficiency (Andres-Alonso et al., 2006; Callen et al., 2003; Reedy et al., 2013). Large donors have powers to become the monitor for the charity performance because they can request detailed financial information, budgets, and plans for each project they finance. Therefore, the fourth hypothesis is proposed as:

H4: Charity organizations with large donors are positively related with the performance.

4. Methodology

Data sources. Dataset for this study was obtained from the ROS. Under the Societies Act 1966 (Act 335) & Societies Regulations 1984, all registered charities are required to submit their audited annual returns including minutes of AGM. The sample in this study focuses on registered charities between 2014-2016. Not all 15,188 charities have provided full information and thus were excluded, and the final sample were 188 charity annual returns.

Dependent variable. Trussel and Parsons (2004) suggest that donors' principal concern is whether a substantial portion of their contribution are utilized towards achieving the organizations missions. The most commonly applied proxies for financial performance efficiency is the used of technical efficiency and allocative efficiency (Andres Alonso et al., 2006; Callen & Falk, 1993). This study used program efficiency ratio which is defined as a ratio of program expenses dedicated to charity total revenues. Higher value is favourable, that indicates organizations utilize most of the funds for charity programs. Thus, the program efficiency ratio is:

TPER = Total program expenses/Total revenue

Control variables. This study used natural log of total assets (LnSIZE) for the size and natural log of number of years since the organization is registered (LnAGE) proxy of the age for the control variables.

Content analysis. This study examines the charity annual returns in seeking the information for all the variables. This study expands the used of content analysis in disclosure studies (Beattie et al., 2004; Coy & Dixon, 2004; Tooley & Guthrie, 2001).

Model specification. Using the panel data for the years 2014-2016, ordinary least squares (OLS) regression is performed to measure the effect of governance practices on the registered charity organizations performance. The equation in the model includes governance factors of board size (BSIZE), the inclusion of outside directors (OSD), volunteers (VDR) and the presence of large donors in board (LDB) as well as the control variables of the organizational size (LnTASSETS) and organizational age (LnAGE).The model is formulated as follows:

$$TPER = \beta_0 + \beta_1 LnBSIZE + \beta_2 OSD + \beta_3 VDR + \beta_4 LDB \beta_5 LnTASSETS + \beta_6 LnAGE + \varepsilon_t$$

5. Results and discussion

Descriptive statistics. Table 1 provides a summary of descriptive statistics for the 2014-2016 panel data, including means, medians, minimums and maximums. The mean of tPER is 24.5, indicating that the charities are operating at moderate performance of 24.5 cents for every ringgit of their charity programs over the total revenue. The mean of board size (BSIZE) is 3.74 indicating that the charities are on average of four board members. However, the maximum of 22 board members is larger than in the corporate sectors. The mean total assets (LnTASSETS) of RM14,300 indicates the charities in the sample have sufficient resources for their operations. The largest charity with RM5.9 million total assets and as low as RM1,000 total assets, with an average of 18 years of establishment (LnAGE).

Table 1: Descriptive Statistics for Selected Variables

Variables	Mean	Median	Max.	Min.
tPER	0.245	0.06	0	0.64
BSIZE	3.74	3.5	1	22
LnTASSETS	14.3k	1.57k	1k	5.9m
LnAGE	18.31	10	1	65

n = 188

OLS regression of tPER. Table 2 reports the OLS regression results of the relationship between dependent variables and other variables.

Table 2: OLS Regression Results

	PER
Constant	0.438(1.46)
BSIZE	0.033*(0.88)
OSD	0.22(1.19)
VDR	0.002*(3.37)
LDB	0.159(1.07)
LnTASSETS	0.004*(-0.020)
LnAGE	0.002*(-1.55)
R^2	0.71
Adjusted R^2	0.63
F-value (p-value)	2.75** 0.001

* Significant at 5 Percent Levels **Significant at 5 And 10 Percent Levels.

The above Table 2 reports that the organizational size (LnTASSETS) and the organizational age (LnAGE) have a negative coefficient which is statistically significant at 5 percent levels. An increase in total assets leads to a decrease in the organizational performance (tPER), and the older the organizations (LnAGE), the lower the performances. These findings are consistent with Reddy et al. (2008), Saunah et al. (2014) and Siciliano (1996). The coefficients of board size (BSIZE), outside directors (OSD), volunteers (VDR) and the presence of large donors in board (LDB) are positive and significant. A plausible explanation is that the larger the board size as well as the inclusion of outside directors, volunteers and large donors in board improve the program efficiency (performance) of the organizations. The results indicate that with the outside directors, volunteers and large donors, the charities are more focused towards fulfilling the mission of the organization, consequently increase the performance by allocating the resources towards charity programs rather than administrative purposes. In other words, all the hypotheses in this study are fully supported.

The findings show that governance practices are crucial in improving the charity's performance and it is relevant to the charity organizations to benchmark the corporate governance practices in managing their day to day operations for better improvement. This finding is consistent with the findings reported by Andres Alonso et al. (2006), Reddy et al. (2008), and Siciliano (1996). The adjusted R^2 in the model shows that 63% of the predictors are explained by the model. The adjusted R-squared increases only if the new term improves the model more than would be expected by coincidental.

6. Conclusion

It is a huge challenge to implement best governance practicesfor NPOsin Malaysia as there is no existing benchmark or specific governance standards, unlikethat of corporate sectors'. The adoption of guidelines or code of best practice of governance allows NPOs to handle funds for public donations or government in order to ensure that members' money is protected for the long term and to curb abuses in management and finance of the NPOs. Therefore, it is necessary to develop a guideline of governance specific for NPOs in Malaysia toallow regulators, such as the ROS, to monitor NPOs operations to ensure that charity objectives are realized, funds are well managed, and the interests of stakeholders and beneficiaries are protected and reflected in key decisions and NPOs are accountable and legitimate to the stakeholders. The current study provides evidence that it is relevant to implement corporate governance practices for the performance of the charity organizations in Malaysia. Future studies may consider other category of NPOs as well.

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